A QUARTERLY PUBLICATION OF THE INTERNATIONAL MONETARY FUND AND THE WORLD BANK

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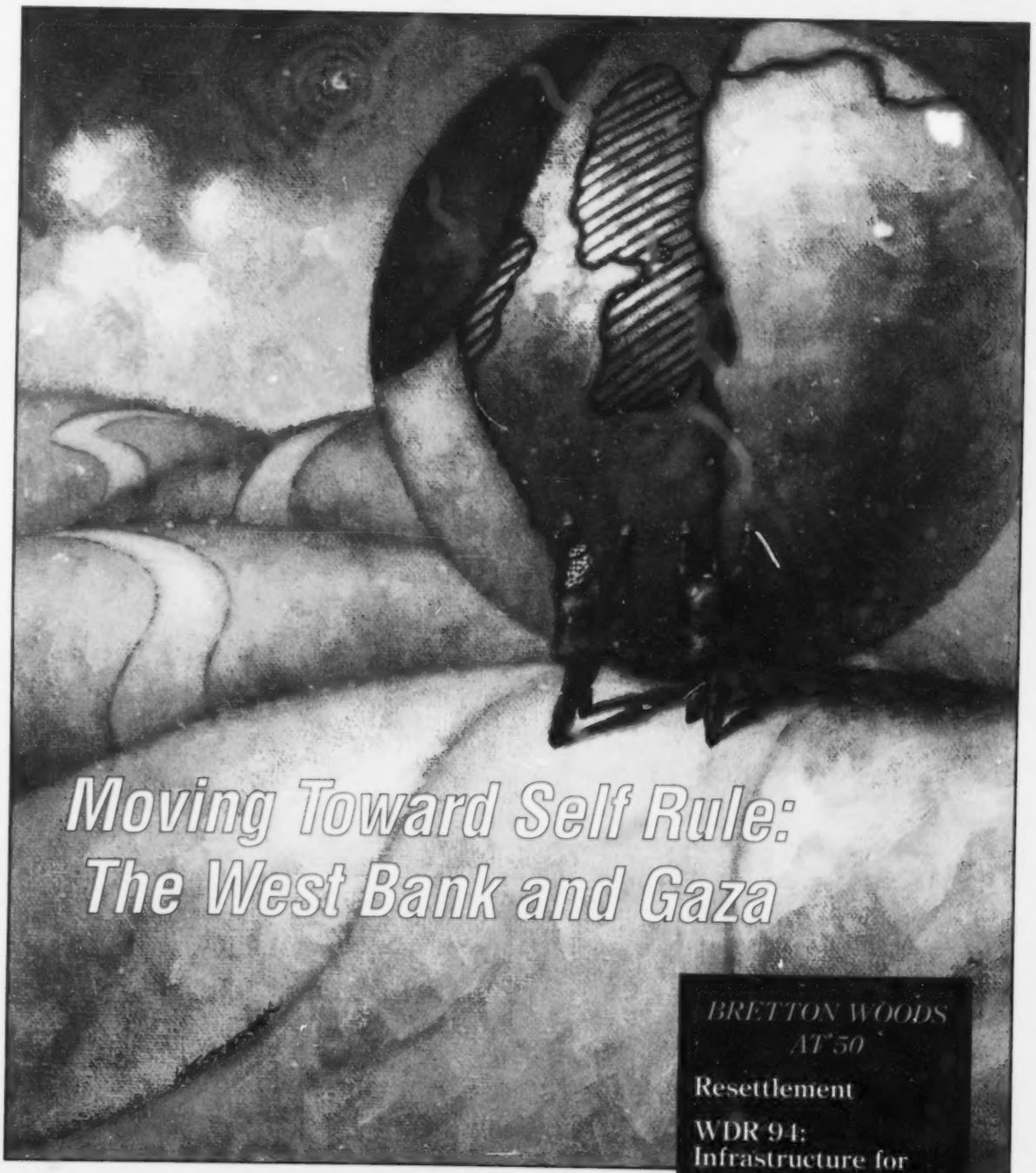

Moving Toward Self Rule: The West Bank and Gaza

BRETTON WOODS AT 50

Resettlement

WDR 94: Infrastructure for Development

Letter from the Editor

A PALESTINIAN state is slowly being born. The steps toward autonomy are only the beginning, however. Indeed, the movement toward self rule will involve a great many challenges. A number of questions arise immediately: what will be the nature of a Palestinian state? What kind of trade arrangements will be put in place? What sort of institutions are needed? And how can the international community help? But while several issues still need to be resolved, one thing is clear: a high degree of economic cooperation between Israel and the new Palestinian entity is essential for economic stability.

This issue focuses on the tasks ahead for the West Bank and Gaza. Ishac Diwan and Michael Walton explore the strategic policy choices at the macroeconomic level that will be faced by the West Bank and Gaza in the future and their implications for economic relations with neighboring regions. Prem Garg and Samir El-Khouri provide an analysis of the Emergency Assistance Program that focuses on the rehabilitation of vital social and physical infrastructure. The priority investments and technical assistance envisioned in the program are needed for securing early and concrete improvements in the daily lives of the Palestinian people and for laying the foundations for longer term economic growth. Regarding links to the outside world, Karim Nashashibi and Oussama Kanaan discuss the strengths and weaknesses of retaining a customs union versus establishing a free trade area with Israel. They conclude that the April 1994 Protocol on Economic Relations achieves an intermediate position that provides for a liberal trading environment that could help sustain the economy and make trade a major source of growth. Establishing a sound system of public finances in the West Bank and Gaza will be necessary to create an environment conducive to private sector development and external assistance. George Abed and Abdelali Tazi explore the key issues in managing public finances.

All parties concerned—the Palestinians, the Israelis, and the donors—have a vital interest in helping the economy of the West Bank and Gaza to evolve into a diversified, productive engine of growth. The progress toward autonomy is an essential building block in the construction of a lasting peace in the Middle East. Fifty years ago, the founders of the Bretton Woods institutions affirmed their belief in the intimate connection between economic development and peace among nations. It is thus fitting that this section appear on the occasion of the 50th anniversary of the World Bank and IMF.

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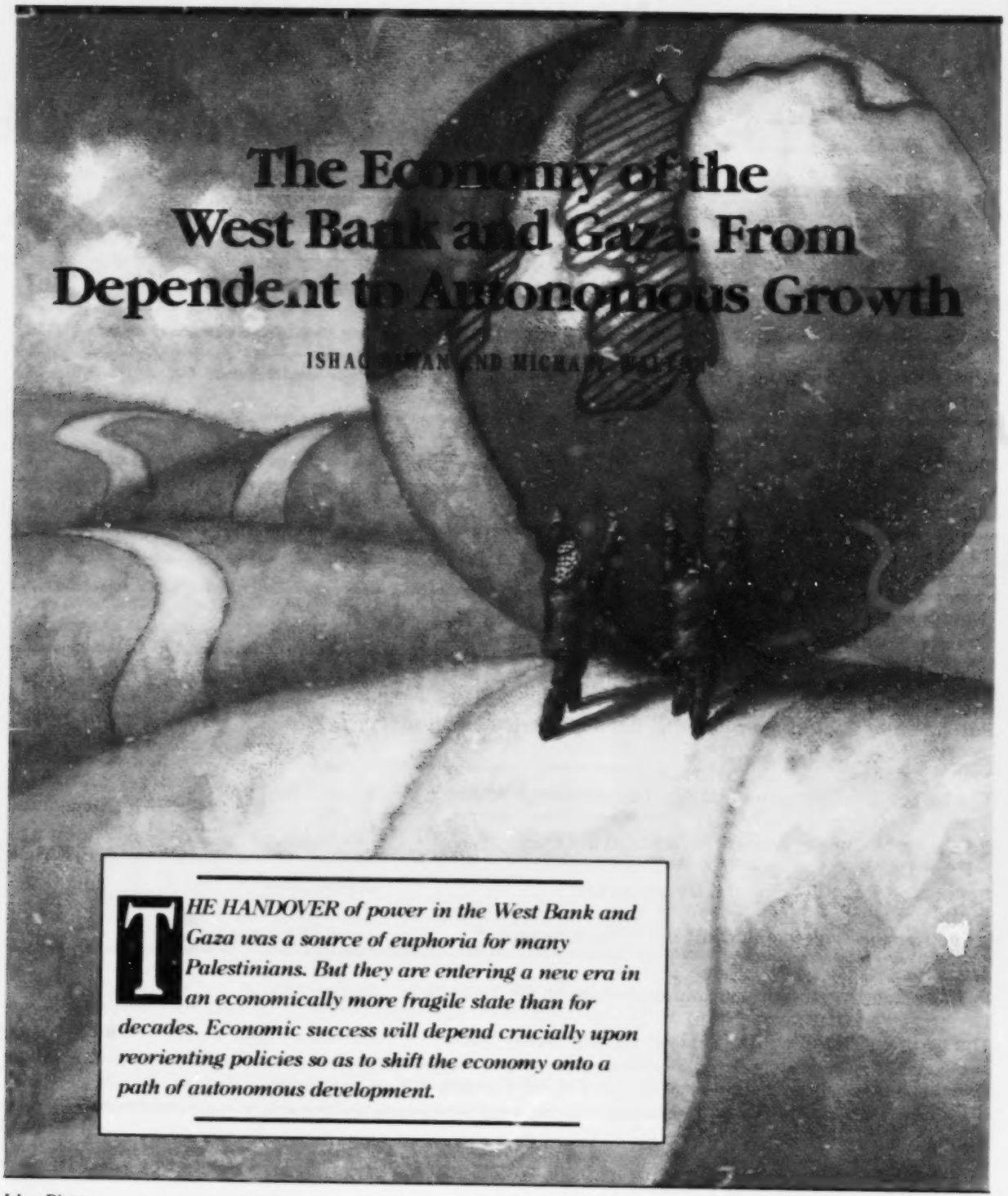
The Economy of the West Bank and Gaza: From Dependent to Autonomous Growth

ISHAC DIWAN AND MICHAEL WALTON



THE HANDOVER of power in the West Bank and Gaza was a source of euphoria for many Palestinians. But they are entering a new era in an economically more fragile state than for decades. Economic success will depend crucially upon reorienting policies so as to shift the economy onto a path of autonomous development.

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The economy of the West Bank and Gaza strip (commonly referred to as the Occupied Territories) is entering a new era of self rule in a state of crisis. Economic difficulties started in the early 1980s, with stagnation setting in after 1987. While expectations of peace fueled a recovery in 1992, this was followed by a severe recession in 1993. Since the late 1980s, open unemployment has increased sharply, underemployment is rampant, jobs for school and university leavers are so scarce that wage differentials have almost disappeared, and poverty has risen dramatically. Many public services are in disarray; municipalities are starved of cash; power outages are frequent; public water supply is below quality standards; and sanitation is very poor.

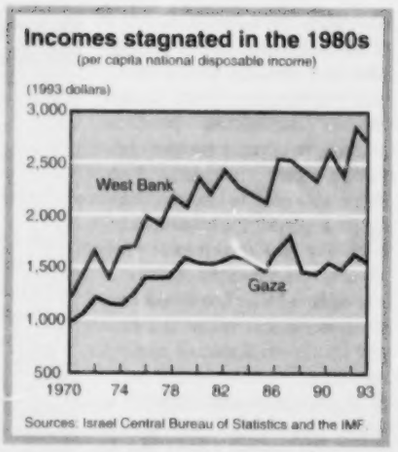
While conditions worsened during the *Intifada* (uprising), starting in late 1987, the fundamental reasons for the present crisis lie in the loss of the past sources of growth of the West Bank and Gaza—employment in Israel and in the Gulf. But the Palestinian Authority also faces potentially major new opportunities. Compared to Eastern Europe and the former Soviet Union, where reform started with an implosion of traditional markets and (for most) only tiny amounts of foreign assistance relative to the size of their economies, the West Bank and Gaza could enjoy a large expansion in trading opportunities, while benefiting from sizable economic assistance. In October 1993, donors pledged $2.4 billion for the reconstruction of the infrastructure in the West Bank and Gaza during the next five years.

But these opportunities could easily be squandered. Ensuring medium- and long-run success will depend on structural policy choices and the building of new institutions to provide employment and raise living standards. This article outlines the issues and choices facing the new Palestinian Authority, in the context of the structures that evolved during the Israeli occupation. Throughout, the focus is on economics rather than on politics. Political events are, of course, crucial for the future, but political progress can be undermined by economic failure.

Patterns of the past

The origins of the present economic crisis lie mainly in the structural imbalances in the past patterns of development. Past economic performance and current economic structures have been profoundly influenced by the 25 years of development under the Israeli occupation. Incomes and wages boomed in the 1970s, stalled in the early 1980s, and declined later in the decade (see chart). The factors underlying the sharp fall in performance are apparent when past growth is decomposed into the components of production (changes in labor force, capital, and productivity of labor and capital). The results reveal that there was rapid growth of the capital stock during both the 1970s and 1980s (indeed, investment rates of 30–40 percent rivalled East Asia) but actual declines in employment. Overall productivity growth, while significant in the 1970s, was negligible in the 1980s for the West Bank and turned negative for Gaza (see table). Throughout, the bulk of capital investment went into housing, and very little into industry.

Much of this pattern was the result of the international and domestic policies that stemmed from the occupation. Policies of both Israel and Arab states created asymmetries in economic relations with neighboring



The West Bank and Gaza—a brief profile

The West Bank and Gaza, together with what are now Israel and Jordan, were among the areas ruled by the Ottoman Empire prior to 1917. Toward the end of World War I, Britain gained control of Palestine, and in 1922, the areas were entrusted to Britain by a mandate of the League of Nations.

Escalating strife and unsuccessful British attempts to mediate between Jewish and Palestinian nationalisms caused Britain to return its mandate to the United Nations in 1947. The UN suggested Palestinian and Jewish independence on a partition basis. The Palestinians and Arabs rejected the suggestion, and the State of Israel was proclaimed in 1948. In the aftermath of the ensuing military conflict, the Gaza Strip came under Egyptian control and the West Bank, under Jordanian control. During the 1967 Arab-Israeli war, the West Bank and Gaza were occupied by Israel, which administered the areas as the occupying power, except that East Jerusalem has been formally annexed by Israel and is considered part of Israel by the Israeli authorities. Israel's annexation of East Jerusalem has not been recognized by the United Nations.

The West Bank and Gaza have a combined area of about 6,000 square kilometers; a 1993 population of 1.8 million; a GNP of about $3.1 billion; and a GNP per capita of $1,725. The population of East Jerusalem is about 300,000, including about 150,000 Jews, mostly settled there since 1967. In addition, there are about 135,000 Israeli settlers residing in some 150 settlements that have been built in the West Bank and Gaza over the past 25 years.

It is estimated that currently about 3.5 million Palestinians live outside of the West Bank and Gaza. Some have maintained residency rights and are, in principle, free to return, while the return of others will be subject to negotiation between Israel and the Palestinians. How many Palestinians might actually return would also depend upon their perceptions of future economic opportunities in the West Bank and Gaza.

Until the recent assumption of authority by the Palestinians, all powers of government concerning the West Bank and Gaza had been vested in the Coordinator of Government Activities appointed by the Israeli authorities. The Civil Administration (CA), working on behalf of the Coordinator, was responsible for administering all economic matters including, inter alia, granting licenses and permits, regulating trade, collecting taxes, organizing public infrastructure and services, and supervising the operations of local governments. The CA had about 22,000 employees, of which approximately 95 percent were Palestinians. Most policy-making and senior administrative positions in the CA were, however, staffed by Israelis. Powers in Gaza and Jericho have been handed over by the CA to the Palestinian authority. According to the Declaration of Principles, signed by Israel and the PLO, the CA would be dissolved following inauguration of the Palestinian Governing Council.

Local-level governments in the West Bank and Gaza consist of 29 municipalities and 96 village councils. In addition, there are 27 refugee camps run by the United Nations Relief and Works Agency (UNRWA). Generally, local governments are responsible for operating power, water, solid waste, and local road services within their jurisdiction; the CA, on the other hand, has direct responsibility for delivering education, health and inter-city road services. The provision of services in the refugee camps is mostly the responsibility of UNRWA.

READEX
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economies. After 1967, there was a surge in opportunities for manual labor in Israel and greater openness to imports from Israel. Exports of competitive products to Israel, however, notably in agriculture, were restricted. Arab states were open to labor and capital flows, but trade in goods was (with limited exceptions) not allowed because of the Arab boycott of Israel. Trade with the rest of the world was, in practice, limited by the weakness of trading networks.

Clearly, these patterns led to a heavy dependence on outside sources of employment, a trade pattern heavily dominated by trade with Israel, and a large trade deficit of some 26 percent of GDP in the late 1980s—financed almost entirely by the substantial flow of labor income from abroad. The number of Palestinians working in Israel rose from zero to about 75,000 in 1979 and to 110,000 by 1987, accounting for 35 percent of the employed population in the West Bank, 45 percent in Gaza, (and all of the growth in Palestinian employment) and 7 percent of total employment in Israel. Further, the oil price hikes of the 1970s fueled a surge in demand for skilled labor in the Gulf, helping pull up domestic wages.

But from the 1980s onward, the picture drastically changed. Growth in Israeli demand for Palestinian labor declined with slower overall growth and the saturation of the market for construction labor; and demand for skilled labor in the Gulf was hit by the fall in the oil price and increasing use of Asian labor, even before the Gulf crisis. By 1992, 21 percent of West Bank income and 29 percent of Gaza's income still came from work in Israel, a significant but unknown amount from the Gulf; only 5–7 percent came from domestic manufacturing.

At the same time, there were heavy constraints on domestic production. Opportunities to invest in domestic production of goods were restricted by an extensive framework of regulations that limited investment in activities competing with Israeli producers. Other restrictions included severe constraints on expansion of industrial land (causing sky-high urban land rents by the 1990s), an underdeveloped formal financial system, and a high degree of uncertainty faced by private producers with respect to their legal position and tax obligations.

Domestic development was further constrained by the under-provision of public goods (water, sanitation, roads, and electric power) that were held by fiscal and institutional constraints to levels far below that in economies of a comparable income level. For example, drinking water per capita is under half that of Tunisia and Jordan, and a quarter of Egypt's; electricity supply per capita is 80 percent of Egypt's and two thirds that of Jordan's. In addition, land and water resource bases have stagnated or declined—in part due to land confiscation by Israel—in the face of a large population increase over the past 25 years.

This mixture of asymmetric integration in the region and regulatory repression at home explains the pattern of growth illustrated in the table. Booming growth in labor incomes abroad pulled the economies along in the 1970s. Domestic production responded, with big shifts of labor from low-return agriculture into services in particular—generating high overall productivity increases. Labor income from abroad financed large private investment (in addition to large imports of consumption goods)—but most of this was in housing, and so had little impact on productive capacity. And when employment abroad stalled, so did domestic production. To make matters worse, the economy was then hit by a series of shocks.

Why the sharp fall in performance?
(percent per annum)

	West Bank		Gaza	
	1970–79	1980–87	1970–79	1980–87
Annual growth:				
GDP	8.54	3.58	6.27	1.57
Capital[1]	8.87	7.95	6.07	6.09
Labor	-0.63	-0.95	-0.74	-0.45
Contribution to GDP growth, of:				
Capital	3.55	3.18	2.43	2.44
Labor	-0.38	-0.57	-0.44	0.27
TFP[2]	5.37	0.95	4.29	-0.60
TFP as a percent of growth in GDP	63.00	27.00	68.00	-38.00

Sources: Israel Central Bureau of Statistics, and authors' computations.
[1] Based on a series constructed from national accounts statistics on investment.
[2] Total factor productivity (TFP) is the residual of the growth accounting equation, assuming a 40 percent capital share.

Recent shocks

The *Intifada* contributed to the post-1987 decline, through strikes, reduction in Israeli demand in nonconstruction sectors, and some tightening of economic controls. But this only sharpened the problem of faltering growth. The unbalanced nature of past economic development left the Palestinian economy highly vulnerable to external economic shocks. Israeli hyperinflation was completely imported in the mid-1980s. West Bank residents could, and did, shift into the Jordanian dinar in 1988–89, but were then hit by the unexpected Jordanian devaluation. The Gulf crisis (1990–91) exacerbated the situation, temporarily leading to a border closure with Israel, and permanently leading to a loss of Palestinian employment in the Gulf, especially in Kuwait, in part because of the Palestine Liberation Organization's (PLO) support for Iraq. It also hastened the financial squeeze on the PLO, which in turn led to reduced grant flows into the West Bank and Gaza.

Following several years of intermittent disruptions caused by curfews and border closures, the number of permits issued for work in Israel was sharply reduced in March 1993. There were security and political reasons for this, but it also marked a turning point in the demand for Palestinian labor in Israel, as the Israeli construction boom faded and new immigrants (mostly from Russia) replaced Palestinian workers in industry and services. The number of workers with jobs in Israel collapsed again in early 1994 due to security concerns, but has gradually increased to about 55,000 at the present time. As a result, the domestic labor market has been hit dramatically in recent years, with falling wages in both the West Bank and Gaza since 1991, and rising unemployment, especially in Gaza.

Post-peace economic strategy

The recent economic shocks—from the Gulf to Israel—add up to a large and permanent adverse change in the external sources of income growth. Future income growth will have to depend on an expansion of domestic production. There is an urgent short-run need to offset the fall in labor demand, to prevent the economy from entering a vicious cycle of falling income and rising social unrest. The creation of jobs at home is also a central medium-term goal to help attract back Palestinian labor from Israel and make room for Palestinians now abroad.

Palestinian economic policymakers face significant policy choices. Should markets in Israel be preserved or trade be reoriented to the Arab world? Should the government play a leading role in jumpstarting the economy, promoting industry, and macroeconomic independence? How will the population cope with

the first years of depressed labor demand? And what is the best use of the foreign capital windfall? Resolving these questions becomes more difficult when the interests of Israel and Jordan are brought into play.

International economic relations. Past development has been characterized by asymmetric integration within the region. If Palestinian wages and employment are to grow, trade in goods will now have to substitute for exports of labor. Does increased autonomy mean disengagement from Israel? This would almost certainly be a mistake from an economic perspective: in the short run, loss in income, especially from those still working in Israel, could send the economy into a vicious downward spiral. In the long run, it would mean forsaking a strategic opportunity—the exploitation of the intermediary position of the Palestinian economy between Israel and the Arab economic world. Turning inward behind trade barriers is also not viable for a small, open economy. An ideal approach would be one that both maintains strong economic ties with Israel—but on more symmetric terms—and diversifies to markets in the region and elsewhere. However, as long as Israel does not have direct economic relations with the other countries of the region, the extent to which they can trade in the West Bank and Gaza will remain limited. Some of these concerns are already evident in the initial economic agreements with Jordan and Israel (see article in this issue by Karim Nashashibi and Oussama Kanaan).

Government spending and taxing. In the past, the economy of the West Bank and Gaza had both too much and too little government. There has clearly been too little in the provision of economic and social services. Expanding infrastructural services will play a vital role in removing constraints or costs to business expansion (e.g., in developing industrial land and in expanding the provision of electric power, roads, and water). This will require policy changes in some areas, such as land allocation decisions, a crash rehabilitation and investment program, and the establishment of the sectoral institutions (most sectors now have some combination of weak public institutions and a multiplicity of nongovernment bodies).

In the medium to long run, both economic infrastructure and social development are central to maintaining the historical comparative advantages of Palestinians (in skills and entrepreneurship) and in supporting the steady reorientation of comparative advantage in favor of greater interdependence. As with trade, an interdependent strategy on infrastructure, for example by strengthening links throughout the region on power grids, transport and telecommunications networks, is going to provide more real autonomy than costly attempts at self-sufficiency. For social services, Palestinians are probably still ahead in skills within the Arab world, though this advantage has been eroded by the large brain-drain. (Since the Gulf war, more skilled workers have returned, contributing to the compression in domestic wage differentials.) A sensible education strategy is likely to require improving quality and a swift modernization of curricula at all levels. The tertiary education system has been heavily oriented toward the academic subjects and the professions. A substantial reorientation is likely to be needed to support growth in skilled employment.

"As with trade, an interdependent strategy on infrastructure . . . is going to provide more real autonomy than costly attempts at self-sufficiency."

But greater provision of these services will require more spending. So, too, will the development of Palestinian police and security (that could require at least 5 percent of GDP). Security and the rule of law is, of course, a necessary condition for any economic activity and is likely to be the main initial concern of the leadership. More public spending implies more finance. Does it mean more taxes? Some of the taxes paid by the residents of the West Bank and Gaza currently accrue to the Israeli treasury (estimated at about 8 percent of GDP). Under the recent economic agreement, these will largely be assigned to the Palestinian Authority. But even then, this will not solve the public finance problem immediately. A major need for the Palestinian Authority will be to widen the tax base and strengthen administration—hardly the most popular enterprise for the new regime.

Regulating for private sector growth. Private entrepreneurship has a crucial role to play in moving the economy onto a more autonomous growth path. A combination of too much and too little public action is also true here: the government has been active in controlling and restricting private production, and has been weak in providing the legal, financial, and institutional infrastructure for private activities. International experience suggests that government direction of economic activity would be costly and counterproductive. But there is an important role for a stronger, not weaker, government in support of private investment.

There are two kinds of policies that affect the business environment: lifting regulatory burdens and building institutions. Lifting regulatory burdens can often be undertaken swiftly and the new Palestinian authority would need to take further steps in this area. Building institutions, by contrast, takes time. In particular, the legal and regulatory systems that are so important to protecting private activity and enforcing contracts need to be carefully fostered. Absence of financial services will also be a short-run constraint on activity. Some checking services are already being provided with apparent efficiency by money lenders, and, as almost everywhere in the world, equity is the primary source of finance for expansion. However, a sound banking system is of great importance to future development, to support the mobilization of household deposits and provide working capital and other financial services to an expanding business community. This will require decisions over entry, banking regulations, and supervision. Some of the groundwork for these have now been laid with the economic agreement with Israel that establishes a Palestinian monetary authority. A forthcoming agreement with Jordan is likely to strengthen banking relations between the two economies.

Macroeconomic policy. Should the new Palestinian Authority have an independent fiscal and monetary policy? The recent agreement leaves this open. Greater independence would be desirable to insulate the economy from shocks from its neighbors (Jordan, in particular, faces significant macroeconomic risks—though some of these are linked to the potential movement of capital into the West Bank and Gaza). In the future, it may be important to manage inflows of capital from Palestinian investors. However, the scope for independence will be limited by the high degree of capital mobility in the region—something already recognized in the common banking requirement for arrangements with Jordan. And the real gains to independence come when macroeconomic credibility is established, something that is hard to earn and that requires a track record of prudence. Indeed, in view of the substantial fiscal pres-

sures that the Palestinian Authority will face in the coming years, stability might in fact be strengthened by the absence of an independent monetary policy.

If a system with an independent currency were chosen, it would be desirable to start with a relatively restricted version, as in a currency board (in which the domestic currency is backed one-for-one by foreign currency). This could gradually evolve to a fully fledged currency that brought greater policy discretion, once discipline and the associated demand for the currency were well established.

Labor demand and poverty in the transition. Employment and real wages will be the primary determinants of the extent and depth of poverty. There are well-developed mechanisms for protecting vulnerable groups via extended family and community networks and the activities of the United Nations Relief and Works Agency. However, these mechanisms are best at dealing with declines affecting selected groups and are least well-equipped to deal with widespread declines in labor demand, since most households and communities suffer adverse effects at the same time.

A pro-labor strategy will be helped by two of the core features of the future strategy. First, the rehabilitation and expansion of social and economic infrastructure will lead to more jobs in the construction phase. Second, permanent jobs should increasingly flow from the reorientation of production as trade in goods substitutes for export of labor.

These measures are likely, however, to leave a significant gap of high unemployment and underemployment. This matters most for unskilled labor, since unskilled workers are disproportionately in poor households with the weakest alternative coping mechanisms. The best way of reaching this group is via low-wage public works, preferably, but not necessarily, in productive activities. Low wages are important both to allow greater employment for a given budget and as a self-selection device for targeting poorer households, as well as to avoid pushing up wages for permanent productive activities. The Civil Administration started a public works scheme after the border closure of 1993, employing up to 20,000 workers at times, depending on the tempo of closures. The stigma of association with the Civil Administration should not deter a program that is an effective way of getting cash to the poor.

But such a transitory policy is to be sharply distinguished from permanent public employment. There is an urgent need to build up the Palestinian administration—indeed, while many Palestinians worked in the Civil Administration, very few were in policy-making positions and thus have little experience in running an administration. In addition, there will also be the task of integrating Palestinian returnees from Tunis. But the size of the civil service needs to be carefully controlled to avoid future fiscal and public pay problems—this could be a difficult area to manage in view of both the slack market for skilled Palestinians and the pool of PLO quasi-public officials now living abroad.

Using external money effectively. Available financing ($2.4 billion) now represents both a one-time opportunity and a potential danger if the economy does not adjust far and fast enough to an autonomous path. The danger is of a failure, on the part of the new Palestinian Authority, the international community, or Israel, to establish the policy and structural conditions that would sustain rapid growth and attract private capital over the medium term. There are many ways in which this could occur. There could be inadequate resolution of the supply-side constraints on growth, whether in the form of the legal framework for private sector activity or tackling infrastructural bottlenecks. Trading opportunities might remain restricted, whether due to failures to improve access in the Arab world, the OECD or Israel, or to an attempt to spur industrialization through trade protection and subsidies. Public savings could stall, owing to failures in revenue mobilization or excessive current spending, and there could be public investment in inefficient and unproductive activities.

Foreign assistance-led growth also creates its own source of vulnerability. Other countries in the world, and many in the Middle East, have experienced booms that ended in busts. When booms are generated by foreign inflows, a reduction of such flows can wreak havoc with the domestic financial system, as well as with social and economic well-being when the system in place is not flexible enough to adjust to a fall in foreign resources. A key principle is that foreign official inflows should complement, not substitute for, the domestic tax effort. Unless there is progress on the domestic front to mobilize resources for development, the provision of external finance in the interim could set the economy of the West Bank and Gaza on a path of external dependency, making it vulnerable to debt crises.

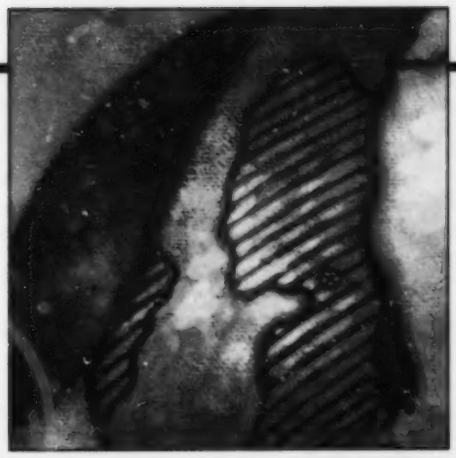
Conclusion

Past economic growth in the West Bank and Gaza was driven by demand for Palestinian labor in outside centers of activity, in Israel and the Gulf. As these sources of growth are disappearing, most Palestinian households are entering the interim period in a more economically insecure state than for very many years. Peace can open opportunities for trade, more independent public action, and foreign resources. These opportunities could be used to reorient the economy toward new, domestic sources of growth or could be squandered. The economic strategy that is chosen is likely to make the difference. Five areas are especially important: maximizing trade linkages; providing the environment for private investment; building institutions—from the health ministry to a private banking system; providing a safety net during what could be a tough transition, especially via temporary publicly financed employment; and managing aid to foster autonomy rather than create dependency, not least by expanding the domestic tax base. Some of these policies will require facing internal conflicts, while others involve negotiations with Israel and Jordan. It is likely that action in all of these areas will be necessary to shift the economy onto a path of autonomous development. ■

At the request of the Multilateral Working Group on Economic Development and Regional Cooperation, the Bank expanded its contribution to the key challenges facing the Middle East region to include an assessment of the development needs and prospects of the economies of the West Bank and Gaza. The result has been a six-volume study, *Developing the Occupied Territories: An Investment in Peace*. The overview volume is complemented by five other volumes that focus on key areas—macroeconomics, private sector, agriculture, infrastructure, and human resource development. This article draws upon the findings of *Volume 2: Macroeconomics*. Prem Garg coordinated the Bank's task force on the Occupied Territories and guided the preparation of the six-volume report.

For further reading, please see:

Program for Development of Palestinian National Economy for the Years (1994–2000), Executive Summary, PLO, Department of Economic Affairs and Planning, July 1993; *Declaration of Principle on Interim Self-Government Arrangements, September 13, 1993*, Appendix I to the Near East Economic Progress Report, No. 1, The Institute for Social and Economic Policy in the Middle East, Harvard University, March 1994; *Protocol on Economic Relations between the Government of the State of Israel and the PLO, representing the Palestinian People, April 29, 1994*, Near East Economic Progress Report, No. 2, The Institute for Social and Economic Policy in the Middle East, Harvard University (forthcoming); *The Economics of Middle East Peace*, edited by Stanley Fischer, Dani Rodrik, and Elias Tuma, The MIT Press, 1993; and *Securing Peace in the Middle East: Project on Economic Transition*, edited by Stanley Fischer, Leonard J. Hausman, Anna D. Karasik, and Thomas C. Schelling, The MIT Press, 1993.



Aiding the Development Effort for the West Bank and Gaza

PREM C. GARG AND SAMIR EL-KHOURI

THE EMERGENCY Assistance Program for the West Bank and Gaza, which directs priority investments and technical assistance, can help channel donor assistance to meet the immediate needs of the Palestinian people and launch the economy on a path of sustainable growth.

Following the historic September 13, 1993, accord between Israel and the PLO, a donors conference was held in Washington, DC, on October 1, where significant financial support was pledged for economic and social development in the West Bank and Gaza. In order to provide a framework to channel this support, an Emergency Assistance Program (EAP) of priority investments and technical assistance to the West Bank and Gaza over the three years 1994–1996 was developed by the Palestinians in collaboration with World Bank staff. The main objective of the EAP is to provide tangible benefits to the Palestinian population quickly, equitably, and efficiently, while laying the foundation for sustainable development over the long term.

Program approach

The approach used in designing the EAP has been heavily influenced by three main considerations. First, the West Bank and Gaza are inheriting very weak and fragmented institutions with little capacity for preparing and implementing development programs. Most policy-making and senior administrative positions in the Israeli Civil Administration were staffed by Israelis. The newly formed 25-member Palestinian Authority, as well as the Palestinian Council for Reconstruction and Development (PECDAR), which was created by the PLO in October 1993 as an interim step toward the management of external assistance and the formulation of economic policy, will require time to develop effective systems and procedures. Municipal institutions also have limited capacity to plan, implement, and manage major investment programs.

Second, there is a need to strike a balance between the imperatives of showing tangible results in the short term and laying the foundation for sustainable growth in the longer term. Thus, investments in public infrastructure and support for private sector development are essential for enhancing human well-being and promoting long-term growth. But the full impact of these investments, in terms of improving employment levels and living conditions, will take time. Therefore, poverty alleviation and employment creation programs are essential during the initial period.

Last, after years of occupation, there is an understandable desire among the Palestinians to manage their own affairs and a reluctance

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Emergency Assistance Program: cost summary

	Year			Area		Total
	1994	1995	1996	Gaza	West Bank	
	(million dollars)					
Public investments						
Transportation	19	28	26	27	46	73
Water and wastewater	22	39	50	44	67	111
Solid waste	13	18	26	25	32	57
Power	33	38	37	32	76	108
Municipalities	17	31	36	32	52	84
Housing	10	10	10	25	5	30
Telecommunications[1]	13	0	0	5	8	13
Education	27	25	26	35	45	80
Health	8	7	3	6	12	18
Agriculture	5	10	11	3	23	26
Subtotal	**167**	**[illegible]**	**227**	**234**	**366**	**[illegible]**
Private sector support						
Telecommunications	15	35	50	50	50	100
Housing	10	25	45	30	50	80
Agriculture	1	7	12	5	15	20
Industry	24	33	43	40	60	100
Subtotal	**50**	**100**	**150**	**125**	**175**	**300**
Start-up expenditure support						
Central administration start-up	108	0	0	50	58	108
Incremental support to NGOs	50	40	27	50	67	117
Subtotal	**158**	**40**	**27**	**100**	**125**	**225**
Technical assistance						
Institution building and training	8	12	7	11	16	27
Policy studies	2	6	3	5	6	11
Project preparation and implementation	7	12	11	14	15	29
Feasibility studies	1	3	4	3	5	8
Subtotal	**18**	**33**	**25**	**33**	**42**	**75**
Total	**393**	**379**	**[illegible]**	**492**	**708**	**1,200**

Source: *Emergency Assistance Program for the Occupied Territories*, World Bank, 1994.
[1] Assumes most investment in the telecommunications sector will be financed by the private sector.

to rely heavily on foreign inputs. However, current institutional weaknesses and shortages of certain technical skills pose a constraint on local implementation capacity. The EAP thus needs to address the imperatives of two competing objectives: to maximize Palestinian inputs on the one hand, and to promote speedy implementation, on the other.

Guided by the above considerations, the Program, among other things, is specifically designed to:

- emphasize short-gestation, rehabilitation, and maintenance activities that make better use of existing infrastructure;
- support a temporary "works program" to help alleviate immediate poverty and unemployment pressures;
- concentrate efforts on areas where living standards are especially low (as in Gaza);
- maximize the use of local inputs, particularly skilled labor. Where necessary, however, outside expertise should be tapped selectively to supplement local capacity;
- make use of local capacity for program implementation, including the UN system, nongovernmental organizations (NGOs), universities, and research institutes;
- emphasize training and institution-building, particularly for management of development programs;
- institute mechanisms for efficient and transparent procurement, accounting, monitoring, and reporting, to ensure effective use of funds; and
- ensure sufficient flexibility to incorporate changes dictated by the unfolding peace negotiations, actual experience with implementation, and the results of the various feasibility studies and technical analysis.

Program focus

The primary focus of the EAP will be on quickly removing the most critical infrastructural bottlenecks. This will be done by rehabilitating and upgrading public infrastructural facilities and services in key sectors of the West Bank and Gaza economy. To avoid stifling private initiative, EAP assistance to these sectors will be limited to areas where private investors are unlikely to play a major role for some time to come.

Other areas for support under the EAP include: (1) promotion of private sector investment; (2) start-up and transitional expenditures for creating and maintaining administrative capacity; and (3) technical assistance to prepare and implement investment activities and develop policies and institutions. With respect to *private sector investment*, the EAP will help create a legal and regulatory environment supportive of private initiative. It will also stimulate private investment in sectors such as industry, tourism, housing, telecommunications, and agriculture by channeling long-term finance to local entrepreneurs.

The *start-up expenditure* component would provide temporary assistance for creating the Palestinian Central Administration. Such assistance would also be provided for a public sector "social safety net" and for maintaining essential services provided by NGOs, many of which have lost traditional sources of support in recent years. NGO activities supported would focus on women and children, education, and health care.

Technical assistance forms an integral part of the EAP and includes about 100 priority activities. Besides immediate help with implementing investments under the EAP, the technical assistance program would include training and institutional development to enhance Palestinians' capacity for self-government and for planning, coordinating, and implementing development programs; policy studies and technical analysis for priority macroeconomic and sectoral issues confronting the West Bank and Gaza; and feasibility studies for priority investments.

Cost and financing

The cost of the proposed EAP, summarized in the table, is estimated at $1.2 billion. Public investment support would constitute 50 percent of total costs; support to the private sector, 25 percent; incremental and start-up expenditure support, 19 percent; and support for technical assistance, 6 percent.

Given the fragility of the public finances of the new Palestinian Authority during the transition period, the donor community will need to finance the proposed EAP entirely with external resources and mainly on highly concessional terms. Finally, the unique circumstances of the West Bank and Gaza, along with the inexperience of the newly created Palestinian institutions, imply that donors will need to keep their procedural requirements simple and to administer their aid programs with more than usual flexibility.

A consultative group meeting for the West Bank and Gaza was held in Paris on December 16, 1993. During the meeting, financial pledges were given or confirmed for a total of $2.3 billion for the five-year transition period ending in 1998. An amount of $580 million

was pledged for 1994, a figure which has subsequently increased to $760 million. The total funds pledged for 1994 and 1995 ($1.3 billion) are sufficient to cover the requirements of the three-year Program, and about 80 percent of assistance for 1994–95 is in the form of grants or loans on highly concessionary terms. The priority now is to match donor pledges to specific sectoral projects and programs, so as to ensure that the Program can be delivered as planned.

Benefits and risks

The challenges involved in implementing the EAP are substantial, but the benefits are also potentially large.

Benefits. The main benefit of the public investment component of the Program would be improvement in the delivery of essential public services. Almost all Gaza residents and about half of the West Bank population would benefit from improved availability of water. Solid waste management programs, drains and sewage, and wastewater treatment facilities would provide Palestinians with a cleaner, healthier environment in which to live and work. Some 80,000 Palestinians living in rural areas would be connected to the main power grids and another 250,000 would gain continuous service. In addition, practically the entire population would benefit from more reliable electric supplies.

In the telecommunications sector, public and private investment would more than double the telephone lines available in the West Bank and Gaza, reducing substantially the large backlog of unmet demand. The housing component of the Program is expected to provide improved shelter for some 20,000 low- and middle-income families, including some 6,000 of the most needy families in refugee camps. The transport component of the Program aims at rehabilitating about 400 kilometers or 20 percent of the road network. The village access road program would upgrade about 160 kilometers of dirt roads to all-weather roads, thereby stimulating new economic activity in rural areas. Substantial benefits would be generated in the form of savings in vehicle operating costs.

The EAP would also help raise the quality of basic education by increasing students' access to modern facilities; modernizing teaching; and reforming educational objectives. In addition, the Program would rationalize and strengthen vocational and university systems. These activities would directly affect over half-a-million students. Investments in health care would directly benefit about 150,000 Palestinians who presently do not have ready access to basic health care services. These investments would also help to contain the cost and increase the effectiveness of health care throughout the system.

An important benefit of the Program would be broad access for Palestinians to enhance their skills, both as a result of the experience they would obtain from participating in programs and through specific program-supported training components. No less important would be the contribution of the technical assistance program in establishing Palestinian institutions. Such assistance would help develop Palestinian capacity for self-government.

Risks. Because the Program is to be implemented under highly unusual circumstances, it faces considerable risks, many of which cannot be avoided. In order of importance, these are:

• *Political risks.* The success of the Program requires stability in the West Bank and Gaza, steady progress in bilateral and multilateral negotiations, and a maturation of internal political processes. Instability in the area would hinder implementation, and delays in bilateral negotiations would slow activities that depend on their outcome. Program success in providing tangible benefits to the Palestinian population could, on the other hand, reinforce the momentum for peace and thereby help with implementation.

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• *Implementation risks.* Implementation will require a well-functioning public administration able to direct, implement, and monitor a rapidly expanding program. Although every effort is being made to ensure proper functioning of PECDAR, there remains some risk of major capacity constraints. Insufficient flexibility on the part of the donors or uncoordinated aid programs could further accentuate this risk, leading to significant delays in Program implementation and in realization of its full benefits.

• *Technical risks.* While the feasibility of some Program components has been assessed, ongoing and planned studies of others may reveal technical, financial, legal, or socioeconomic issues that cannot be resolved within the time span of the Program. The impact of problems of this kind on the overall Program is likely to be limited, however.

• *Program risks.* Major deviations from the Program as currently proposed such as implementation of activities of questionable technical or financial feasibility, or unsustainable budgetary demands, could occur, reflecting political pressures and domestic or external funding. While the likelihood of some "political" projects being financed appears considerable, these risks would diminish provided PECDAR plays its planned role in a professional, transparent fashion.

Next steps

To maintain and strengthen the momentum toward peace, the Palestinian population must see the benefits of the external assistance as quickly as possible. To support the process of economic and social development in the West Bank and Gaza, critical actions are necessary on the part of the Palestinians, Israelis, and donors.

The Palestinians need to: (1) initiate the process of institution-building to handle critical administrative and developmental functions, particularly making PECDAR fully operational; and (2) launch without delay already prepared projects and programs, such as the World Bank-supported Emergency Rehabilitation Project.

The Israelis need to: (1) ensure speedy approval of permits and clearances to facilitate the work of newly created Palestinian institutions, such as PECDAR, so that they can perform their functions efficiently; and (2) facilitate donor investments and aid flows in the West Bank and Gaza by granting, where appropriate, visas, immunities, and tax exemptions according to international practice.

The donor community has the responsibility to: (1) work closely with PECDAR to transform aid pledges into firm commitments against specific programs and projects; (2) strengthen donor coordination so that pledges match with agreed sectoral investment needs and priorities; and (3) standardize and simplify as far as possible procedures relating to procurement, disbursement, auditing, and progress reporting, while insisting on the agreed criteria of efficiency, accountability, and transparency in the use of aid money. ■

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Which Trade Arrangements for the West Bank and Gaza?

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AS THE West Bank and Gaza gain increasing autonomy, critical strategic choices emerge on the nature of economic links to the rest of the world, particularly neighboring countries. The April 1994 Protocol on Economic Relations between Israel and the West Bank and Gaza provides for a liberal trading environment that could help sustain the economy—indeed making trade a major source of growth.

In the past, growth in the West Bank and Gaza was largely sustained by earnings of Palestinian workers in Israel and in the Gulf countries. As this source of income is on a decline, employment opportunities within the West Bank and Gaza will need to be increased. The first steps toward Palestinian autonomy provide the opportunity, as well as the resources, to reorient the production base and to reduce the dependency of the Palestinian population on employment in Israel. But how should this reorientation in the productive base be effected? What growth strategy should be pursued, and what kind of trade regime would be consistent with this strategy?

The specific trade provisions in the Protocol on Economic Relations between Israel and the West Bank and Gaza, which was signed on April 19, 1994, generally preserve the overall framework of a customs union but allow significant exceptions that would help promote trade with the Arab world. But is this necessarily the best trade arrangement for the West Bank and Gaza? Assessing the provisions of the Protocol requires reviewing the external trade arrangements that would be most desirable for the West Bank and Gaza in order to achieve high and sustainable growth.

A desirable trade strategy

The choice of an appropriate trade strategy largely depends on the characteristics of the economy and geographical factors. Clearly, the option of turning inward would be very costly for a small economy such as the West Bank and Gaza. The limited domestic market and the need to establish reliable sources of sustainable growth provide little room for inefficient import substitution and "infant industry" type protection. Distances to neighboring countries are small, transportation costs are low, economic links with Israel are intertwined, and borders will be porous, particularly in the context of regional peace. Domestic production will have to be efficient from the outset, targeting potential effective demand for specific products in neighboring countries and at the regional level. Hence, the only trade strategy

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that can underpin a relatively high and sustainable growth would be an outward-oriented, export promotion strategy, which would maximize the gains from trade. While in the coming years residential construction and the buildup of infrastructure in the West Bank and Gaza may become major sources of growth, over the longer term, only exports can provide a steady and reliable engine of growth.

With this particular growth strategy, the trade regime acquires special significance. Two factors can make or break this strategy: competitiveness and market access. The trade regime must minimize investment costs of new production facilities while encouraging choices of techniques that would be consistent with the West Bank and Gaza's resource base. Hence capital equipment, as well as inputs to industrial and agricultural production, need to be obtained from the cheapest sources. Moreover, access to markets in Israel and to other neighboring and industrial countries must not be hindered by tariffs, nontariff barriers, other trade restrictions, and subsidies.

Against these efficiency considerations, other factors must also be taken into account. A Palestinian entity would require, in addition to external aid, substantial budgetary resources to rehabilitate its social and physical infrastructure. As in most developing countries, such resources would have to come mostly from indirect taxes, including trade taxes. At the same time, trade promotion and regional integration would also require some degree of indirect tax harmonization with Israel and other neighboring countries, such as Jordan and Egypt, which have lower sales taxes than Israel and with whom trade relations may rapidly expand. Hence, the choice of the trade regime will have to strike the right balance between ensuring productive efficiency and other macroeconomic and regional objectives.

West Bank and Gaza need to diversify production and expand exports
(selected economic indicators, 1993)

	Israel	Jordan	West Bank and Gaza
	Billion dollars		
GDP	65.6	5.2	2.7
GNP	64.7	5.0	3.7
	Dollars		
GDP per capita	12,262	1,171	1,500
GNP per capita	12,093	1,126	2,055
	Percent of total		
GDP by sector			
Agriculture	4.4	8.0	17.0
Industry	30.2	20.4	6.1
Construction	8.7	5.9	14.7
Services	56.7	65.7	60.2
Exports/GNP	22.4	25.0	7.3
Imports/GNP	31.1	70.8	29.6
External current account deficit/GNP	-2.1	-13.0	-10.9
Population (millions)	5.4	4.4	1.8

Source: *International Financial Statistics*, IMF, and staff estimates.

The way it was

During the Israeli occupation, the composition and pattern of trade in the West Bank and Gaza became severely skewed. The resulting sectoral distribution of output became equally imbalanced—the domestic productive base, particularly agriculture and industry, was suppressed, while services were encouraged. The trade regime between Israel and the West Bank and Gaza was characterized by the absence of barriers to Israeli exports to the West Bank and Gaza but strict restrictions on its exports to Israel, in particular on agricultural products. This unequal customs union also skewed the pattern of trade by confining most of the West Bank and Gaza's external trade to Israel. In particular, while the West Bank and Gaza were economically integrated with Jordan prior to 1967, trade with Jordan was virtually eliminated except for some exports of agricultural products. During 1980–86, an average of 70 percent of the West Bank and Gaza's exports went to Israel and an average of 80 percent of its imports emanated from Israel. Trade deficits in both agricultural and industrial products with Israel have resulted in merchandise trade deficits averaging $385 million per year in 1980–86 or about 20 percent of GDP (see table). The deficits were largely financed by a trade surplus in invisibles averaging $237 million per year in 1980–86, mostly in the form of export of labor services to Israel and to Gulf countries.

The customs union with Israel was particularly unequal with respect to trade in agricultural products, an area where the West Bank and Gaza could claim a historical comparative advantage. Agricultural exports to Israel were limited to about $36 million per year in 1980–86, due to restrictions on vegetable exports. On the other hand, agricultural imports from Israel averaged $92 million per year in the same period. An important factor that adversely affected the development of the agricultural sector in the West Bank and Gaza was the Israeli government's policy of subsidizing Israeli agriculture. Subsidies on factors of production used in farming, credit to farmers at concessional rates, export finance, and a minimum price level for several agricultural products through the intervention of marketing boards were provided. Total subsidies on Israeli agriculture, including imputed subsidies on water but excluding subsidies on credit, averaged about 32 percent of the value of agricultural output during 1984–90.

The extensive governmental support to Israeli agriculture contrasted sharply with the lack of support for agriculture in the West Bank and Gaza. Whereas irrigation water is provided to Israeli farmers at subsidized rates, the government has imposed substantial restrictions on the use of irrigation water in the West Bank and Gaza and has regularly diverted water from aquifers for use in Israel and by Israeli settlements. These policies have led to a relative decline in output as well as a deterioration in the quality of a number of agricultural crops, especially citrus fruits. In addition, Palestinian farmers receive no subsidies or tax rebates on their agricultural inputs, although they are subjected to the same high tariffs on the import of such goods as their Israeli counterparts. In the course of time, these asymmetries have repressed the development of agriculture in the West Bank and Gaza. While the share of agriculture in GDP has fluctuated around 18 percent, much of it is of poor quality and destined for domestic consumption.

An objective of the agricultural strategy in the West Bank and Gaza should be to expand and diversify the production of crops for export, with a view to gradually transforming the agricultural sector into a stable source of foreign exchange. This will involve a gradual shift in the composition of agricultural output away from subsistence crops and toward a high value-added output mix (fruits, vegetables, and horticulture) as outside markets—in particular Israel's and Europe's—become accessible.

As for industrial products, although there have been few restrictions on exports to Israel, nontariff barriers were erected to limit such exports, largely through licensing and quality requirements. In addition, Israeli industry, as with agriculture, has benefited from subsidies. Industry in the West Bank and Gaza received no such support, and has been subjected to strict licensing regulations, discouraging the establishment of large industrial enterprises. Furthermore, Palestinian producers were not entitled to the tax rebates on their exports that the Israeli producers received on the VAT and customs duties paid on inputs.

A further constraint on the development of the industrial sector has been the absence of a developed system of financial intermediation. This has stifled risk taking and entrepreneur-

ship, limiting investment largely to housing. The small scale of operations and the low ratio of capital to labor in Palestinian manufacturing have led to low labor productivity, which often could not justify the relatively high wages of Palestinian labor induced by the demand-pull effect of employment opportunities in Israel. This has resulted in an anemic industrial sector, mostly based on a cottage-industry type of manufacturing, with about 90 percent of all firms employing eight or fewer workers. The share of industry in GDP has stagnated around 8 percent since 1968, well below the range of 20 to 30 percent of other countries with similar income levels and significant agricultural sectors. It is thus expected that an export-oriented industrial strategy would lead to an increase in the share of industry in GDP, both by increasing the number of industrial enterprises and by expanding the scale of their operations and improving production techniques.

Which trade arrangement?

In light of the past asymmetries in trading patterns, what sort of trade arrangement would be needed to address these imbalances? The growth strategy envisaged for the West Bank and Gaza suggests that the underlying trade relations with Israel and neighboring Arab countries should evolve to facilitate the shift in the production mix, broaden the pattern of trade toward its Arab neighbors and other countries, and create a trade environment that will stimulate exports and promote efficient import substitution.

So far, the gains from trade have been essentially one-sided: Israeli agricultural products have penetrated large segments of the West Bank and Gaza market, and Israeli manufactured products have dominated it. In the face of this overwhelming market penetration, some Palestinians are prepared to erect tariff barriers against Israeli products, and reorient their external trade toward Jordan and Egypt. Given the contiguity and potential complementarity between Israel and the West Bank and Gaza, such an approach would result in major welfare losses for the West Bank and Gaza and, to a lesser extent, for Israel. But even beyond economic considerations, it would also jeopardize the peace process—since the best investment in a lasting peace is fostering strong economic relations that would benefit both sides.

The real challenge for the Palestinians, therefore, is to maintain free trade with Israel provided the impediments to the development of industry and agriculture are removed and the regulatory framework harmonized to enable the West Bank and Gaza to compete with Israel on equal footing. If these conditions are realized, the West Bank and Gaza should be able to recapture a sizeable portion of its own market and penetrate the Israeli market, which is about 20 times larger.

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A first step for the Palestinian Authority would be to liberalize trade relations with Israel, as was done under the Protocol, and establish a level playing field for the two economies on trade in goods and services. In particular, the removal of nontariff barriers, such as unduly high specification standards on certain industrial products, would need to be negotiated to facilitate the expansion of industry in the West Bank and Gaza. At the same time, given Palestinian development objectives, imports of capital goods and intermediate products should be obtained from the lowest-cost producers with minimal customs taxation. This is essential to minimize fixed investment costs, ensure the appropriate factor proportions, and help the economy of the West Bank and Gaza establish areas of comparative advantage. On the other hand, in order to encourage savings and provide revenues to the budget, the Palestinian Authority would need to impose relatively higher indirect taxes on consumer goods.

With these objectives in mind, should the West Bank and Gaza establish a customs union with Israel or a free trade area? Under a customs union, the West Bank and Gaza and Israel would maintain free trade between them and have a common external tariff vis-a-vis the rest of the world, whereas under a free trade agreement, the two countries would maintain free trade between them but adopt separate tariffs vis-à-vis the rest of the world. An important advantage of entering into a customs union arrangement is its ease of administration. The Palestinian Authority would not have to formulate a new customs tariff, erect border posts in Israel, have its goods inspected by Israeli border posts, or lose budgetary revenues. It would only need to set up a small customs administration to collect customs directly on imports coming through the Jordanian and Egyptian borders, and set up revenue sharing arrangements of trade taxes with the Israeli authorities. With a high premium on scarce administrative resources in the West Bank and Gaza during the initial restructuring phase, this approach would facilitate a quick and well-funded empowerment of a Palestinian tax and customs administration.

On the negative side, however, opting for a customs union would mean that the West Bank and Gaza would have to adopt the same tariff structure prevailing in Israel. To the extent that the Israeli tariff protects Israeli producers from outside competition, it becomes a tax on the Palestinian producer if the product is used as an input, and a tax on the consumer, entailing both an efficiency and welfare loss. For example, tariffs on durable consumer goods are as high as 70 percent in Israel. With more than 20 percent of gross industrial output in Israel consisting of durable consumer goods, the tariff brings substantial gains to Israeli producers, whereas, with no durable consumer goods produced in the West Bank and Gaza, no such gains accrue to Palestinian producers. Therefore, the trade diversion costs for the West Bank and Gaza (i.e., using Israeli products versus cheaper foreign products) may be significant, and the trade-off between the gains from trade creation versus the losses from trade diversion may be more favorable to Israel than to the West Bank and Gaza. Israeli tariffs on investment goods—averaging 21 percent—would also be higher than what developmental objectives in the West Bank and Gaza would warrant. However, Israel is now engaged in a process of trade liberalization, through which quantitative restrictions have been eliminated and tariffs are expected to be reduced to maximum rates of 8 percent to 12 percent by 1998. Provided this liberalization proceeds on schedule, the trade diversion costs of a customs union would be short-lived and worth bearing.

A free trade agreement, on the other hand, would allow the Palestinians to structure their own external tariff, taking into account their own developmental needs. However, the design of a new tariff and setting up a customs administration to collect customs duties on all imports would take considerable time and resources. Moreover, the Israeli authorities

would want to ensure that third country products do not enter Israel through the West Bank and Gaza at low tariffs. The Palestinian authorities would also need to establish their own rules of origin. Defining "domestic content" and enforcing such rules of origin can be unnecessarily contentious in an environment where confidence building steps—which are essential for the success of the Peace Accords—should be emphasized.

The Protocol agreement

The trade regime established under the recently signed Protocol on Economic Relations addresses many of the concerns expressed above. Essentially, the Protocol has adopted the best features of a customs union and a free trade area by creating a liberal trade regime. It establishes a customs union between Israel and the West Bank and Gaza where the Israeli import tariff, other trade taxes, as well as import licensing and standards, have been accepted by the Palestinians for most imports. The Protocol allows goods to move between Israel and the West Bank and Gaza without any customs duties or import taxes (quantitative restrictions, however, will still apply to six agricultural commodities but will be phased out by 1998). Customs duties and other trade taxes collected by the Israeli authorities would be remitted to the Palestinian Authority for the goods imported by the West Bank and Gaza on a net basis according to the "destination principle."

Two important exceptions, however, have been introduced in the customs union with Israel. First, the Palestinian Authority has been allowed to establish its own import policy and tariff structure for certain products and countries. A first step at diversifying the pattern of trade in the West Bank and Gaza was taken by the Palestinian Authority in developing trade ties with Arab countries. For this purpose, two lists of goods have been established: a list of goods locally produced by Jordan, Egypt, and other Arab countries, and a list of foodstuffs to be imported from Arab and other countries. The Palestinian Authority will determine customs policy and procedures with respect to these two lists, including tariffs and other charges.

Second, the Authority will also determine customs duties and other taxes for goods imported (capital equipment and wood products) for their economic development program. Further, the Authority will be able to impose its own tax rates on motor vehicle imports, which are a major source of budgetary revenue for the countries of the region, and to import petroleum products—which it can obtain at cheaper prices than Israel—for sale in the areas under its jurisdiction at prices that it can set, with the exception of gasoline. The price of gasoline would remain within 15 percent of the Israeli price to prevent arbitrage operations.

In sum, the Protocol can potentially succeed in addressing several Palestinian concerns:

- It opens up the Israeli market to agricultural products and other goods subject to the restrictions mentioned above that, in any case, will be phased out.
- It diversifies external trade in the West Bank and Gaza by establishing direct economic links with Arab and other countries; in particular, it establishes a bridgehead toward restoring the broad economic relationship that existed with Jordan prior to the occupation.
- It gives the Palestinian Authority the opportunity to import capital equipment and foodstuffs from the cheapest sources and impose its own low tariffs on these imports. On the other hand, there will be inputs, particularly to agriculture, that are not included in the three lists defined by the Protocol, and that will continue to be subject to the Israeli tariff structure. The impact on resource allocation of these customs duties (versus Palestinian duties) is open to question but, in any case, is not expected to be large.
- It provides the Palestinian Authority with tax handles by allowing it to set its own taxes on motor vehicles, petroleum products, and consumer appliances imported from Arab countries. At the same time, the Authority will collect trade taxes on all other imports from Israel, thereby sparing the Authority considerable administrative expense and problems in setting and collecting trade taxes for all imports.

On the other hand, the Protocol appears to have a number of limitations that are worth mentioning. First, imports from Arab countries will be limited by "market needs," as determined by a Palestinian-Israeli Joint Economic Committee, established under the Protocol. Some of these imports can only originate from Egypt or Jordan. These restrictions could be gradually liberalized in the context of broader regional trade arrangements, including with Israel, which would be established once a comprehensive peace is attained.

Second, while the Protocol establishes free movement of goods between the two sides, it does not address the wide array of subsidies and other nontariff barriers that benefit some Israeli sectors and products. Presumably, the Palestinian Authority would be free to provide similar protection to its own production, but this would go against the elimination of distortions that should govern trade liberalization and would also entail budgetary costs. A more efficient approach would be for Israel to scale down its own subsidy system and restrictive practices, starting with commodities competing with Palestinian products or set up a compensation system for Palestinian producers.

Third, the thorny issue of access to water and water charges has not been addressed and would presumably be left for settlement after the peace process takes hold. Yet, as water is a major input to agriculture and industry, the establishment of equitable water rights and the setting of "economic" water charges will be essential for an optimal development of both Palestinian and Israeli agriculture.

Finally, land is another important factor of production that is critical for the expansion of the Palestinian productive base and residential construction. About 40–50 percent of land in the West Bank and Gaza has been transferred to the Israeli authorities following the occupation. While it will take some time to fully resolve this highly sensitive issue, it would be helpful, as a confidence-building measure, for the Palestinian Authority to recover some of this land and establish clear land registration practices.

Conclusion

Establishing economic autonomy and self-sustaining development in the West Bank and Gaza means diversifying trade patterns and relations, shifting from dependence on remittances from the export of labor, that are now in decline, to a broader production base and interdependence with other parts of the region and the world. The options with regard to retaining a customs union with Israel or establishing a free trade area suggest that both have costs and benefits, and some elements of each may not be politically feasible in the short term. Hence, some form of intermediate position would be both preferable and feasible taking into account Palestinian development and trade objectives. Notwithstanding its limitations, the Protocol achieves such a position, establishing a liberal trade environment that would be consistent with an export-oriented growth strategy for the West Bank and Gaza. More important, it can serve as a cornerstone for further trade liberalization and diversification that would help foster greater economic integration. Whether the Protocol can achieve this potential will largely depend upon additional measures, which redress some of the existing imbalances, particularly with respect to removing some nontariff barriers, establishing equitable access to water, and devising a system for fair property settlements. ■

Laying the Foundation: A Fiscal System for Palestinian Autonomy

GEORGE T. ABED AND ABDELALI TAZI

AS THE PALESTINIAN authorities of the West Bank and Gaza take over financial responsibility from Israel, many challenges emerge. One of the most pressing for the Palestinians is to establish an efficient and credible fiscal system—a cornerstone in the overall structure for economic, financial, and monetary management.

The process of transfer of authority in the West Bank and Gaza from Israel to a Palestinian Interim Self-Governing Authority, when completed, will represent the first real experience in self-government for the Palestinians. The opportunities are immense, but so too are the challenges.

The financial system that is ultimately developed will constitute the keystone in the broader administrative structure for self-government in the West Bank and Gaza. This task takes on added importance and urgency for a number of reasons. First, domestically generated resources are critical for financing basic social services for the population. Second, the Palestinian authorities need to demonstrate their capacity to mobilize and manage public funds in a credible manner to satisfy the requirements for transitory external support for start-up expenditures as well as for

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longer-term development assistance. Third, beyond these immediate concerns, competent fiscal management is essential for creating a stable macroeconomic environment conducive to saving and investment and for attracting needed private capital inflows.

The difficulties that lie ahead must not be underestimated. Not only are the development needs of the West Bank and Gaza considerable, but the indigenous institutional capacity to respond to the new challenges has remained underdeveloped. The Palestinian people, among the most highly educated and entrepreneurial in the region, have had little opportunity and scant experience in self-governance. Further, the region has been suffering from a hemorrhage of professional talent for decades. The task of reconstruction and development, sufficiently challenging under normal circumstances, is made even more difficult by the need to integrate the Palestine Liberation Organization institutional machinery into a civil society in the West Bank and Gaza and by the large-scale need for institution building.

The current fiscal system is largely an extension of the highly developed system in Israel. Although the Protocol on Economic Relations allowed for changes in some aspects of the tax system, the core operation of the fiscal system as a whole is likely to be maintained, at least for the short term. This system has been managed almost entirely by Israelis. Their departure, therefore, leaves a void of expertise that will need to be filled quickly.

The incoming Palestinian authorities, therefore, must make the necessary preparations, including consultations with the Israelis, recruiting and training key personnel, and acquiring and operating sophisticated computerized systems, to ensure a smooth takeover of fiscal administration. This is essential to maintain continuity and, above all, to protect budget revenues, especially during the critical initial period.

This article, based in part on the IMF's Technical Assistance work on taxation and public expenditure management in the West Bank and Gaza, describes the process underway and specifies the actions that would be required in the area of fiscal management that derive from the Protocol and other agreements.

The current system

The fiscal system in the West Bank and Gaza originated in the British mandate administration in Palestine (1922–1948) and was developed further during 1948–1967 under a Jordanian administration in the West Bank and an Egyptian trusteeship in the Gaza Strip. The separation of the two areas led to the development of two different legal systems and traditions. Since 1967, Israeli amendments to existing legislation have been effected through military orders promulgated separately in each of the two areas, giving rise to a complex, and in some aspects, incoherent legal system. In the fiscal area, the operational aspects of the system of taxation and public expenditure management have in effect been made to converge with those of Israel. Thus, personal income and company profit taxation is largely similar to that in Israel, while the value-added tax (VAT) is identical. Budgeting and treasury operations are integrated into the Israeli financial management systems.

Under the Israeli administration, fiscal functions have been performed mainly by the Israeli Civil Administration (ICA), which prepared and executed the budget for the West Bank and Gaza under the direction of the Office of the Coordinator for the Territories in the Ministry of Defense. The Palestinian local authorities (municipalities and village councils) are largely self-financed and prepared their own separate budgets; these are approved by the ICA. More than half of these budgets represent the operations of public utilities.

Major sources of revenue for the West Bank and Gaza are income taxes (both personal and corporate), the VAT, customs and excise duties, health and other fees, as well as transfers from Israel, comprising benefit-related deductions made from earnings of Palestinians working in Israel. According to World Bank estimates, the revenue effort in the West Bank and Gaza averaged about 24 percent of GDP during 1987–91, of which 12.5 percentage points represented central administration revenue, 3.5 percentage points local revenue (including public utility revenues), and about 8 percentage points customs, VAT, and commodity taxes paid by residents of the West Bank and Gaza that accrued to the Israeli Treasury (see table). According to the Protocol, indirect taxes collected by Israel on goods imported into the West Bank and Gaza from or via Israel are to be remitted to the Palestinian revenue authorities under a mutual arrangement on revenue clearance.

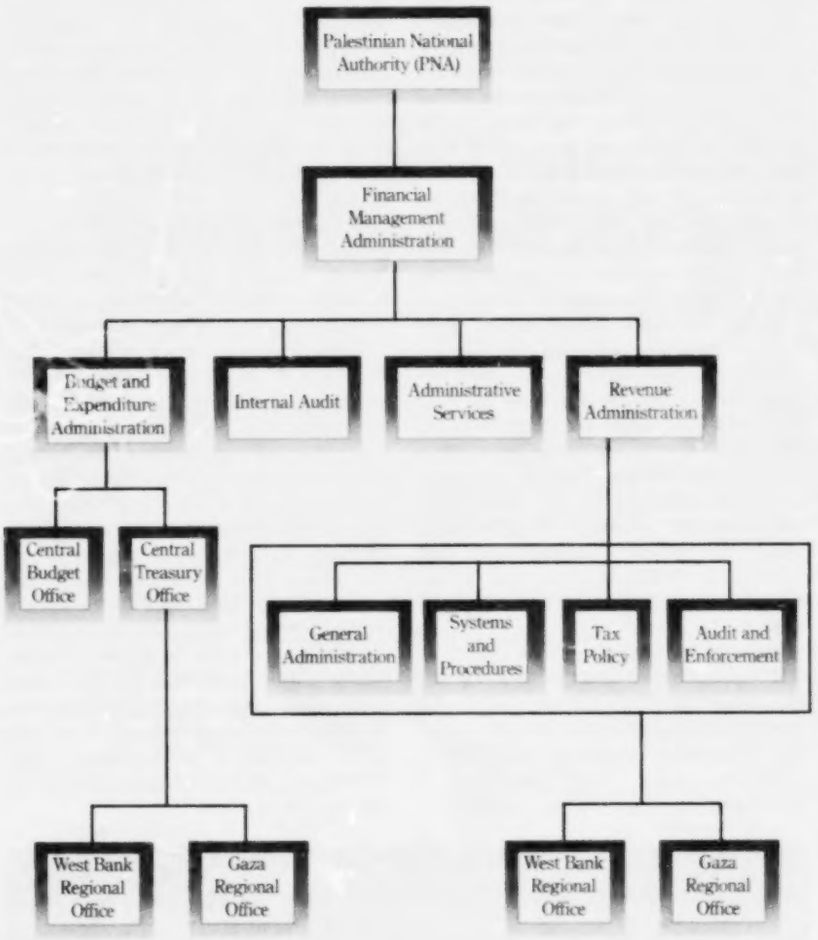
Current expenditures constitute more than 85 percent of total budget outlays, covering mainly payroll and other recurrent expenditures in the main traditional areas of education, health, and social welfare. Development expenditures are relatively small and depend on the availability of funds. In addition, there are a number of expenditures outside the government system that have a large impact on the economy of the West Bank and Gaza. The United Nations Relief and Works Agency (UNRWA) provides relief and social services to the refugee population, estimated at about 940,000, mostly in the Gaza Strip, while several hundred nongovernmental organizations (NGOs) provide various economic, social, and cultural services to the population. Both UNRWA and the NGOs have no formal link with the ICA.

Revenue and expenditure comparisons

	Average: 1987–91				1989
	Egypt	Israel	Jordan	West Bank and Gaza[1]	Developing countries
	(percent of GDP)				
Revenue	23.1	38.6	27.2	24.1	22.1
Tax revenue	15.2	33.9	14.3	16.1	17.5
Direct taxes	5.7	17.5	3.4	4.2	5.4
Indirect taxes	9.5	16.4	10.9	11.9[2]	12.1
Nontax revenue	7.9	4.7	12.9	8.0	4.6
Expenditure	42.2	50.2	46.4	–	28.0
Current expenditure	28.9	45.7	37.2	–	21.0
Development expenditure	13.3	4.5	9.2	–	7.0
Expenditure excluding defense	37.2	36.8	30.5	25.8	25.6
Current expenditure excluding defense	23.9	32.3	21.3	22.6[3]	18.6
Development expenditure	13.3	4.5	9.2	3.5	7.0
	(percent of GNP)				
Memorandum items					
Revenue	21.7	39.4	28.9	17.8	23.3
Of which: indirect taxes	8.9	16.7	11.6	8.9	12.7

Source: *Developing the Occupied Territories: An Investment in Peace*, World Bank, 1993.
[1] Comprises central and local government (including public utilities).
[2] Includes revenues accruing to Israeli treasury.
[3] Includes expenditures by UNRWA and NGOs.

The new Palestinian fiscal structure



The transfer process

According to the Cairo Agreement of May 4, 1994, the transfer of authority to the Palestinians for the Gaza and Jericho areas was completed on May 18, 1994. According to the Declaration of Principles, the transfer of authority in the rest of the West Bank would come in two stages. First, the Palestinian Authority would assume responsibility for all taxation in the Gaza/Jericho areas and for direct taxation (income and profit taxes and property taxes) in the entire region. The agreements identified four other "early empowerment" sectors—education, health, social welfare, and tourism—whereby complete authority would pass to the new Palestinian Authority. Second, the transfer of the remaining functions would follow elections in the West Bank and Gaza and the establishment of a Governing Council, after which the ICA would be dissolved. At the same time, a central Financial Management Administration will also become necessary, with jurisdiction over both the West Bank and the Gaza regions.

Although the need for continuity and the close integration with Israel constrain the Palestinian authorities' understandable desire to develop their own independent fiscal systems, the Protocol already provides a reasonable margin of flexibility. In the area of direct taxation, the Palestinian authorities may exercise full control. In the case of indirect taxation, however, the powers of the Palestinian authorities are somewhat more circumscribed. The Protocol essentially confirms the *de facto* customs union between Israel and the West Bank and Gaza but gives the Palestinians authority to set import policy, including tariff rates, standards, and valuation procedures for a broad range of goods expected to be imported from Jordan and other Arab countries. Similarly, the VAT and excise regimes may differ, although deviations are expected to remain limited. With the exception of basic food commodities and inputs necessary for economic development, the Palestinian authorities are likely to introduce only small variations in customs rates from those currently in effect because changes now could have a negative impact on badly needed fiscal revenue. Over the medium to long term, wider departures from the current systems may be considered in light of the emerging development requirements of the economy of the West Bank and Gaza.

The new administration

In the process of moving toward self-rule and creating new institutional arrangements, the Palestinian authorities have to keep the new administration relatively small and efficient. The needed expansion in public services should be sought more through upgrading of skills and improved efficiency than growth in size.

A central Financial Management Administration (FMA) is in the process of being established to replace the ICA and other Israeli Government institutions previously engaged in financial operations in the West Bank and Gaza (see chart). The FMA would have overall responsibility for all public revenue and expenditure functions in the West Bank and Gaza, with the regional administrations operating under its supervision. Relationships between the FMA and local authorities may need to be re-examined in the new circumstances.

The tax functions of the new administration are to be consolidated in a unique Palestinian headquarters for central tax administration. The Central Budget Office would prepare the consolidated budget within a consistent macroeconomic framework and would coordinate with other agencies, like UNRWA and the NGOs, with regard to investment budgeting and social affairs. It would also supervise the budgets of local authorities.

The Central Treasury Office would be a key component in the financial operations of the central administration with regard to budget execution and control; cash and debt management; and accounting and fiscal reporting. The Central Treasury Office's relationship with the Palestinian Monetary Authority and with the banking system would need to be defined. The budget decision-making process must be transparent, with safeguards to ensure appropriate review and consent by the legislature and broad popular support. Thus, for example, in order to improve tax compliance, existing tax legislation would need to be translated into Arabic, simplified and explained to a skeptical public through extensive taxpayer education campaigns. The link between the need to mobilize domestic tax

revenues and the funding of essential social services should be emphasized. Budget formulation would also need to be coordinated with other Palestinian entities, particularly with the Palestinian Council for Reconstruction and Development (PECDAR) and the Palestine Monetary Authority. In view of the importance of indirect tax revenues collected by Israel for transfer to the Palestinian authorities, procedures for information exchange and coordination with Israel are being instituted.

The staffing of the new Palestinian administration presents challenges. The central financial administration would need to be almost totally reconstituted. This would require the recruitment and training of at least 40 senior staff and about 200 others. So far, only a small proportion of the staffing requirements can be met from the existing professional talent. However, with the high level of education and experience in proximate fields (e.g., accounting, finance, and law), administrative capacity should develop rapidly with the provision of intensive training and expert advice—an area in which the IMF is currently involved.

Even as the Palestinians proceed to establish and operate their own tax and budgeting systems in the West Bank and Gaza, the close integration of the economies of the West Bank and Gaza and Israel, as well as their geographic proximity, requires tight coordination. This is especially true in the area of revenue administration where, because the computer systems are linked, access to information is crucial. Thus, agreement has been reached allowing Israeli and Palestinian authorities to cooperate to ensure effective tax compliance on trade between Israel and the West Bank and Gaza. Further, to reduce the risks associated with fraudulent activity, procedures are being instituted for information sharing between the two authorities concerning the verification of transactions and the transfer of goods on a correctly taxed basis. These arrangements are being made through the Joint Economic Committee created by the Protocol.

Opportunities and risks

Although the PLO agreements with Israel provide the Palestinians with the opportunity for self-governance that could form the basis for even greater independence in the future, the risks and difficulties are real and considerable.

In addition to the clear need for institution building for the long term, the Palestinians are also expected to be running all aspects of civilian authority, including domestic security, for over 2 million people in the West Bank and Gaza. Critical to their capacity to do so is the degree to which they are able to take charge of and operate the fiscal system, and especially to generate the level of domestic revenue commensurate with the agreed requirements for external budget support. The Palestinians themselves have estimated that the 1994 current budget (covering less than a full year as the new authorities will take over gradually over the course of the year) would require external financing of about $125 million, or about 40 percent of estimated current and start-up expenditures over the same period.

Beyond the first or possibly the second year, outside budget support, which is essentially associated with the "exceptional" nature of expenditures in the initial period, is expected to decline. Lacking the institutional capacity for domestic borrowing to finance a budget deficit, the Palestinian authorities essentially are constrained to implement a balanced cash budget, especially as other alternatives are unpromising or unattractive. Given that some of the external development assistance is being provided in the form of loans and that the capacity of the Palestinians to service external debt is untested and uncertain, the Palestinian authorities should naturally resist the temptation to borrow abroad. The accumulation of domestic payment arrears, the only remaining alternative, would have severe destabilizing effects and could undermine the credibility of the whole enterprise. This situation only underlines the urgency of measures to build up domestic revenue-generating capacity and to institute effective budgeting and public expenditure controls in order to achieve the required level of fiscal performance.

Beyond the transfer period

For the immediate period ahead, the primary concern for the incoming Palestinian administration is to maintain continuity in the existing fiscal operations—collecting tax revenue, meeting public expenditure obligations, and coordinating with the Israeli and Jordanian authorities on issues of mutual concern. Superimposed upon this critical task is the need to rehabilitate existing public institutions and build new ones to address medium- and long-term development requirements.

In this regard, one of the most crucial tasks being addressed is the elaboration of a legal system that would lend support and credibility not only to future fiscal policy but also to all other economic and financial policies. These include the implementation of the development program, the encouragement of private investment, and the regulation of private sector activity, as well as the delineation of boundaries between the public and private sectors in the emerging Palestinian society.

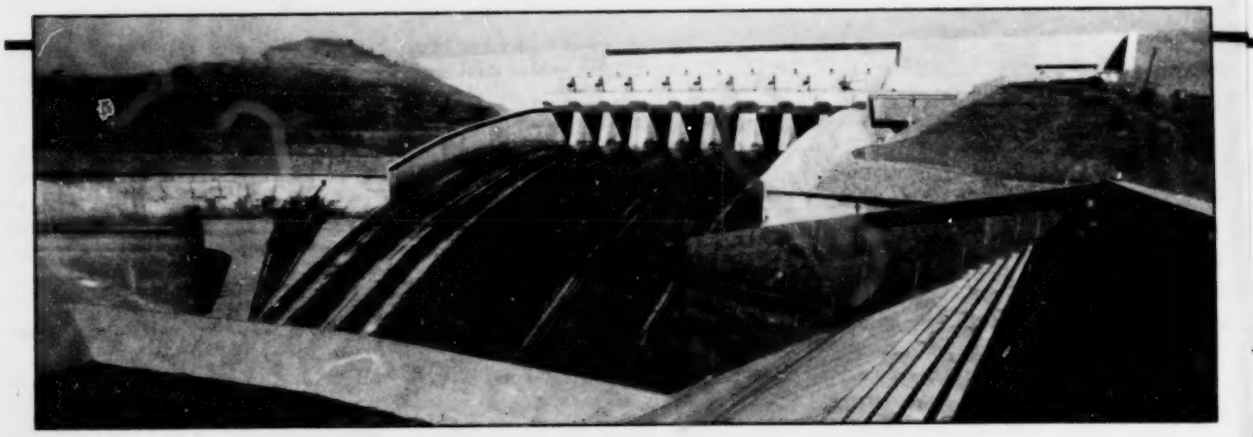
The development of a more coherent legal framework is particularly important in the area of tax policy, where several issues are likely to be on the short- to medium-term agenda of the Palestinian authorities. Such issues include the review and simplification of existing income tax legislation, reform of municipal finances, unification of tax systems in Gaza and the West Bank, the establishment of a tax appeals system, as well as issues related to possible double taxation with Israel and with Jordan. Similarly, in terms of expenditure management policy, a budget law with accounting and auditing regulations is in the process of being formulated within the broader legal framework that is to be instituted.

A key determinant of success in institution building in the fiscal area in the West Bank and Gaza will be the recruitment and training of professional manpower for fiscal administration. To this end, the IMF has already provided technical assistance in connection with the transfer of functions and the administration of systems in taxation and expenditure management and has agreed with the Palestinian authorities on a medium-term program of technical assistance. This includes training seminars and workshops and the assignment of long-term experts in the field to advise the Palestinian authorities in the areas of tax administration, budgeting, treasury management, systems development, and training.

Foundations for growth

The Palestinian authorities' success in efficiently mobilizing domestic revenue and prudently managing public expenditures could be crucial in establishing the credibility and effectiveness of the new Palestinian Authority. More important, this success would provide the needed assurances not only to external aid donors committed to financing the bulk of the public sector investment program, but also to private sector investors, especially among Palestinians living abroad, to exploit the long-neglected investment opportunities in the West Bank and Gaza. The effective use of external funds in the initial period, given the paucity of domestic resources for investment, are critical for laying the foundation for a strategy of accelerated growth in later years.

The high quality of human resources in the West Bank and Gaza, the dynamism of the Palestinian private sector, the absence of external debt, the tourism potential, and the proximity to the much larger and fast-growing economies of Israel and Jordan are all factors aiding the prospects for rapid growth. The achievement of healthy growth within a stable macroeconomic environment, underpinned by prudent fiscal and monetary management, could have important implications for peace and progress not only in the West Bank and Gaza but also in the entire Middle East region. ■



Infrastructure for Development

GREGORY INGRAM AND CHRISTINE KESSIDES

GOOD infrastructure services are essential to achieve economic growth and to improve the quality of life. But for most developing countries—despite improvements in access—the quantity and quality of services are well below what is demanded. Solutions lie in better institutional incentives, including involving the private sector in service delivery.

Developing countries invest $200 billion a year in new infrastructure—4 percent of their national output and a fifth of their total investment goes to transport, power, telecommunications, water supply, sanitation, and irrigation. The result has been a dramatic increase in infrastructure services (Chart 1). During the past 15 years, the share of households with access to clean water has increased by half, and power production and telephone lines per capita have doubled. All regions have enjoyed per capita gains.

These accomplishments are no reason for complacency, however. One billion people in the developing world still lack access to clean water, and nearly 2 billion lack adequate sanitation. In rural areas especially, women and children often spend long hours fetching water. The already inadequate transport network is deteriorating rapidly in many countries. Electric power has yet to reach 2 billion people, and in many countries unreliable power constrains output. The demands for telecommunications to modernize production and enhance international competitiveness far outstrip existing capacity. On top of all this, population growth and urbanization are increasing the demand for infrastructure.

Responding to these shortcomings is critical because the adequacy of a country's infrastructure helps determine its success or failure in diversifying production, expanding trade, coping with population growth, reducing poverty, or protecting the environment. Good infrastructure also raises productivity, lowers production costs, and improves living standards. Indeed, infrastructure capacity grows in step with economic output—a 1 percent increase in the stock of infrastructure is associated with a 1 percent increase in GDP across all countries.

But coping with infrastructure's future challenges involves much more than a simple numbers game of drawing up inventories of infrastructure stocks and plotting needed investments on the basis of past patterns.

Inefficiency and waste claim a large share of resources that could be used for delivering infrastructure services. A review of power utilities in 51 developing countries shows that technical efficiency has actually declined over the past 20 years. Older power plants consume between 18 and 44 percent more fuel per kilowatt hour than do plants with best "practice" technology. Port facilities in developing countries on average move cargo from ship to shore at only 40 percent the speed of the best-performing ports. And half the labor in African and Latin American railways is estimated to be redundant.

These failings in investment and operating efficiency are not compensated by success in addressing poverty or environmental concerns. Badly designed and managed infrastructure is a source of environmental degradation in both urban and rural areas. The poor not only consume fewer infrastructure services (public transport, sanitation, clean water and power)—they also have less access to services that meet their demands for quality and affordability, and so are often forced to pay more than the rich for inferior service. In most countries, rural areas receive fewer infrastructure services than urban areas

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(with the obvious exception of irrigation), even in such essential services as drinking water.

Inadequate maintenance has been an almost universal (and costly) failure of infrastructure providers in developing countries. For example, a well-maintained paved road should last for 10–15 years before needing resurfacing, but lack of maintenance can lead to severe deterioration in half that time. An examination of completed Bank highway projects shows that, on average, the estimated economic returns to projects involving primarily maintenance are almost twice as high as returns to projects for new construction. Inadequate maintenance means that power systems in developing countries have, on average, only 60 percent of their generating capacity available while best practice systems in developing countries achieve levels over 80 percent. And water supply systems deliver an average of 70 percent of their output to users—compared with design targets of 85 percent.

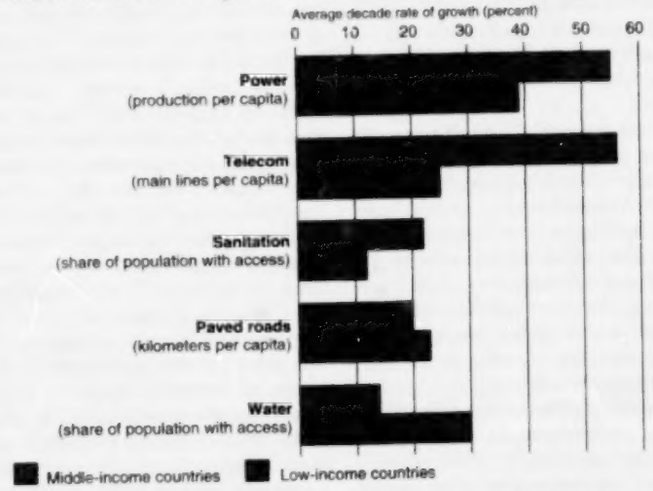
Failings in maintenance are often compounded by ill-advised spending cuts during periods of budgetary austerity. Shortfalls in maintenance expenditure have to be compensated for later by much larger expenditures on rehabilitation or replacement. Donor objectives (such as seeking contracts for capital-goods supply or consultancy services) may also play a part in the preference for new investment over maintenance. In many low-income countries, donor financing underwrites nearly half of all public investment in infrastructure.

Misallocated project investments by many countries have created inappropriate infrastructure or provided services at the wrong standard. Demands of users for services of varying quality and affordability go unmet even when users are willing and able to pay for them. Low income communities are not offered suitable transport and sanitation options that provide services they value and can afford. Premature investments in capacity—especially in water supply, railways, power, ports, and irrigation—have often absorbed resources that could otherwise have been devoted to maintenance, modernization, or improvements in service quality.

This poor performance provides strong reasons for doing things differently—in ways that make better use of new and existing resources to meet the demands of users. In short, the concern needs to broaden from increasing the *quantity of infrastructure facilities* to improving the *quality of infrastructure services*. Fortunately, the time is ripe for change. In recent years, there has been a revolution in thinking about who should be responsible for providing infrastructure facilities and services, and how these should be delivered to the user.

Chart 1

Infrastructure has expanded tremendously in recent decades



Note: Based on telecom, sanitation, and water data for 1975–90, and road and power data for 1960–90.
Source: *World Development Report 1994*, World Bank.

Against this background, the *World Development Report 1994* (*WDR 1994*) considers new ways of meeting public needs for services from infrastructure—ways that are more efficient, more user-responsive, more environment-friendly, and more resourceful in using both the public and private sectors. The report reaches two broad conclusions:

- Because past investments in infrastructure have not had the development impact expected, it is essential to improve the effectiveness of investments and the efficiency of service provision.
- Innovations in delivering infrastructure services—along with new technologies—point to solutions that can improve performance.

Why the problems?

As developing countries look for ways to tackle insufficient maintenance, misallocated investment, unresponsiveness to users, and technical inefficiencies, it is critical to understand why these problems have become so pervasive. The *WDR 1994* found, perhaps surprisingly, that although the availability of infrastructure (per capita coverage) tends to be correlated with GDP per capita, efficiency and effectiveness of infrastructure provision are not. Consequently, plots of coverage against performance in water, power, telecommunications, roads, and railways show little relationship across a wide sample of low- and middle-income countries. Moreover, there is no close correlation between a country's efficiency of provision in one sector and its performance in another.

These findings indicate that efficiency and effectiveness of infrastructure provision derive not from general conditions of economic growth and development, but from the institutional environment, which often varies across sectors in individual countries. This suggests that changes in the institutional environment can lead to improved performance, even when incomes are low, because in each sector some low-income countries perform well. As a corollary, even many high-income countries give evidence of waste and inefficiency in infras-

tructure when the policy and institutional conditions are poor.

What are the main reasons for poor performance? First, the delivery of infrastructure services in the developing world usually takes place in a market structure with one dominating characteristic: the absence of competition. These services often are provided by centrally managed, monopolistic public enterprises or government departments. This holds for almost all irrigation, water supply, sanitation, and transport infrastructure, and it held almost universally for telecommunications until a few years ago.

Second, those charged with delivering infrastructure services are rarely given the needed managerial and financial autonomy. Managers are often expected to meet objectives at variance with what should be their primary function—the efficient delivery of high-quality services to satisfy customer demand. Public entities are required to serve as employer of last resort or to provide patronage, besides being compelled to deliver services below cost. At the same time, public providers are rarely held accountable for their actions. Few countries set well-specified performance measures, and inefficiency is often compensated for by budgetary transfers.

Third, the users of infrastructure—both actual and potential—are not well positioned to make their demands felt, since prices typically do not reflect costs. For example, power prices in developing countries cover only half the supply costs on average. Water charges and rail passenger fares typically cover only a third of costs. Excess consumer demand based on below-cost prices is not a reliable indicator that services should be expanded, though often it is taken as such. Users can express preferences in other ways (e.g., local participation in planning and implementing new infrastructure investments), but they seldom are asked.

Creating the institutional and organizational conditions that oblige suppliers of infrastructure services to be more efficient and more responsive to the needs of users is clearly the challenge. But is it possible? Several converging forces are opening a window of opportunity.

• Technology is changing the way infrastructure can be provided in most sectors. In telecommunications and power generation, technological innovation has eroded economies of scale; electronic devices permit remote-controlled metering of electricity, water, and gas use (and eventually may permit more direct road pricing); a variety of new technologies, such as digitalization in telecommunications, reduce the cost and complexity of maintenance; and computerized systems facilitate network operations.

• Economic adjustment in many countries through the 1980s has led to a new pragmatism regarding the roles of government and of the market. The worldwide liberalization of markets, and insights about the potential for institutional reforms have changed attitudes about the relative risks from market and government failures.

• The shift toward more pluralistic and decentralized governance in many developing countries has strengthened public pressures for more affordable and environmentally friendly solutions in infrastructure.

These trends have been reinforced by a surge of initiatives to provide and finance infrastructure in new ways.

Options for the future

For a more effective and efficient delivery of infrastructure services, the *WDR 1994* advocates three elements of institutional and policy reform:

Apply commercial principles of operation by giving service providers focused and explicit performance objectives, well-defined budgets based on revenues from users, and managerial and financial autonomy, while also holding them accountable for their performance. Governments should therefore refrain from ad hoc interventions in management, but provide explicit transfers, where needed, to meet social objectives, such as public service obligations. Private sector involvement in management, financing, or ownership will in most cases be needed to ensure a lasting commercial orientation in infrastructure.

Broaden competition by arranging for suppliers to compete for an entire market (e.g., firms bidding for the exclusive right to operate a port for ten years), for customers within a market (telephone companies competing to serve users), and for contracts to provide inputs to a service provider (firms bidding to provide power to an electric utility).

Involve users more in project design and operation of infrastructure, especially where commercial and competitive practices are insufficient to provide the information needed to make suppliers more accountable to their customers. Involvement of users and other stakeholders can include consultation during project planning, direct participation in operation or maintenance, and monitoring.

These elements apply whether infrastructure services are provided by the public sector, the private sector, or public-private partnership. However, numerous examples of past failures in public provision, combined with growing evidence of more efficient and user-responsive private provision, argue for a significant increase in private involvement in financing, operation, and—in many cases—ownership.

How rapidly and extensively private involvement can increase in any country depends on the strength of the private sector, the administrative capacity of the government to regulate private suppliers, the performance of public sector providers, and the political consensus for private provision. With this in mind, the *WDR 1994* sets out a menu of four main options for ownership and provision, which must be tailored to fit each country's needs:

Option A. Public ownership and public operation. Public provision by a government department, public enterprise, or parastatal authority is the most common form of infrastructure ownership and operation. Successful public entities run on commercial principles and give managers control over operations and freedom from political interference, but they also hold managers accountable by using performance agreements or management contracts. And they follow sound business practices and are subject to the same regulatory, labor law, accounting, and compensation standards and practices as private firms. Tariffs are set to cover costs, and any subsidies to the enterprise are given for specific services and in fixed amounts. Water authorities in Botswana and Togo and national power companies in Barbados and Thailand perform well, as do the highway authorities in Ghana and Sierra Leone and the restructured road agency in Tanzania. But few successful cases of Option A persist, because of their vulnerability to changes in governmental support.

Option B. Public ownership with private operation. This option is typically implemented through lease contracts for full operation and maintenance of publicly owned infrastructure facilities—or through concessions, which include responsibility for the construction and financing of new capacity. The private operator typically assumes all commercial operation risk and shares in investment risk under concessions.

Leases and concessions are underway for railways in Argentina, water supply in Buenos Aires and Guinea, and port facilities in Colombia, Ghana, and the Philippines. Concessions to build and operate facilities include toll roads in China, Malaysia, and South Africa; power plants in Colombia, Guatemala, and Sri Lanka; water and sanitation facilities in Malaysia and Mexico; and telephone facilities in Indonesia, Sri Lanka, and Thailand.

Option C. Private ownership and private operation. The use of this option is increasing, both through new entry by private firms in infrastructure markets and through divestiture of public ownership of entire systems. Private ownership is straightforward when services can be provided competitively. For example, 27 developing countries allow cellular telephone service to be competitively provided, and many others allow private firms to construct electric generating plants and sell power to the national power grid. The necessary competition can also occur across sectors—between road and rail, and electricity and gas.

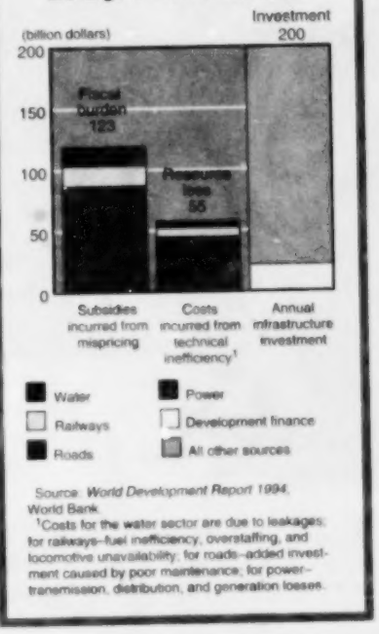
Where systems are being fully or partly privatized and there is no cross-sectoral competition, regulation of private and public providers may be required to prevent monopoly power abuses. Experience with regulation and systemwide privatization in developing countries is still new. Chile's form of regulation, which involves regular, automatic price adjustments and a well-specified arbitration system, appears to be working well.

Option D. Community and user provision. This option is most common for local, small-scale infrastructure—such as rural feeder roads, community water supply and sanitation, distribution canals for irrigation, and maintenance of local drainage systems—and it often complements publicly provided services. Successful community provision needs user involvement in decision-making, especially to set expenditure priorities so as to ensure an equitable and agreed sharing of the benefits and costs. Technical assistance, training, and compensation to service operators are also important. When these elements are present, community self-help programs can succeed over long periods, as in the Gurage community roads organization in Ethiopia, which has handled local maintenance since 1962.

Chart 2

Potential payoffs from reform

Annual gains from eliminating mispricing and inefficiency are large relative to investment



Source: *World Development Report 1994*, World Bank.

¹Costs for the water sector are due to leakages; for railways–fuel inefficiency, overstaffing, and locomotive unavailability; for roads–added investment caused by poor maintenance; for power–transmission, distribution, and generation losses.

Financing and payoffs

Where will the money come from to implement these options? Private financing in one form or another now accounts for about 7 percent of total infrastructure financing in developing countries, and its share may double by the year 2000, while bilateral and multilateral foreign aid accounts for around another 12 percent (about a third of the latter comes from the World Bank and the International Development Association). Although an increasing share of the domestic savings needed to finance infrastructure provision can come from private sources, governments will continue to be a major source of funds for infrastructure as well as a conduit for resources from the donor community. As transitional measures to provide long-term financing where sufficient private support is not likely, some governments are revitalizing existing infrastructure lending institutions and creating specialized infrastructure funds.

In future, governments will often need to be partners with private entrepreneurs. The lessons of this experience to date are that these partnerships should start with small, simple projects; investors' returns should be linked to project performance; and any government guarantees needed should be carefully scrutinized. The task is to find ways to route private savings directly to private risk-bearers making long-term investments in infrastructure projects that each have unique characteristics and for which no single financing vehicle is appropriate. Official sources of finance, such as multilateral lending institutions, can facilitate the process by supporting the policy and institutional reforms needed to mobilize private financing and use it more efficiently.

The payoffs from increasing the efficiency of infrastructure provision will differ from country to country and from sector to sector, given the great variation in performance. But the rewards are potentially large across the spectrum, making the commitment to reform very worthwhile. First, a reduction in subsidies in power, water, and railways alone would reduce the fiscal burden by nearly $123 billion annually—or about 10 percent of total government revenues in developing countries, 60 percent of annual infrastructure investment, and approximately five times annual development finance for infrastructure (Chart 2). Though eliminating underpricing would not produce a net resource saving to the economy (as the costs would be covered by users), the fiscal relief would be substantial.

Second, service providers stand to gain from better technical efficiency. The savings possible from raising operating efficiency from today's levels to best practice levels are estimated at around $55 billion a year—pure savings equivalent to 1 percent of all developing countries' GDP, a quarter of annual infrastructure investment, and twice annual development finance for infrastructure. Looked at another way, if the annual technical losses of $55 billion could be redirected for three years—at current costs of roughly $150 per person for water systems—the 1 billion people without safe water could be served.

Finally, improvements in productivity and pricing would permit more effective delivery of service in response to demand and enhance the growth and competitiveness of the economy. They would also allow vastly greater mobilization of resources for needed new investments—by generating higher revenues and by creating a policy environment conducive to the inflow of new resources. ■

The World Development Report 1994 *has been prepared by a team led by Gregory K. Ingram and comprising John Besant-Jones, Antonio Estache, Christine Kessides, Peter Lanjouw, Ashoka Mody, and Lant Pritchett. The work was carried out under the general direction of Michael Bruno.*

Making Public Infrastructure Entities Commercial

ANTONIO ESTACHE

AS DEVELOPING countries examine ways of improving the delivery of infrastructure services, reforming public enterprises along commercial lines looks quite promising. The* World Development Report 1994 *calls for a 3-pronged approach that includes corporatization, explicit contracts, and improved cost recovery.

In spite of impressive progress by developing countries over the last two decades, many people, especially the urban and rural poor, do not yet have access to even minimal infrastructure services. Increasingly, the private sector may be called upon to play a role in improving coverage, but the onus will continue to be on the public sector for several reasons.

First, for the foreseeable future, the public sector is likely to remain responsible for over 80 percent of expenditures on infrastructure. Second, private alternatives are not yet as common in the poorest countries as in middle-income countries. Third, even in countries with a dynamic private sector, some infrastructure services such as road networks and major public works will remain predominantly in the public domain. And fourth, strategic, regulatory, or political reasons pressure governments in many developed and developing countries to retain the responsibility for building and operating infrastructure.

However, as the *World Development Report 1994* brings out, governments in developing countries have tended to do poorly in managing the flow of infrastructure services. A survey of World Bank-financed projects designed to improve infrastructure performance reveals the most common problems (see table).

- The goals of public sector infrastructure providers are often ambiguous and changing because governments are forced to balance many, often inconsistent, economic, social, and political objectives.
- Managers do not control day-to-day operations—or decisions on prices, wages, employment, or budgets. Utilities' prices, for instance, are often imposed on managers regardless of resulting constraints on their ability to pay for inputs, including salaries.
- Because the financial status of public

Common management problems in public sector infrastructure entities

(percentage of total loans to a sector in which a specific problem was identified, 1980–92)

Sector	Number of loans	Source of problem			
		Unclear goals	Lack of management autonomy and accountability	Financial problems	Wages and labor problems
Electricity	48	27	33	73	31
Water	40	25	48	70	35
Telecoms	34	18	38	53	32
Rail	39	15	21	54	33
Road	35	9	23	40	40
Ports	28	21	36	32	43

Source: World Development Report 1994, World Bank.

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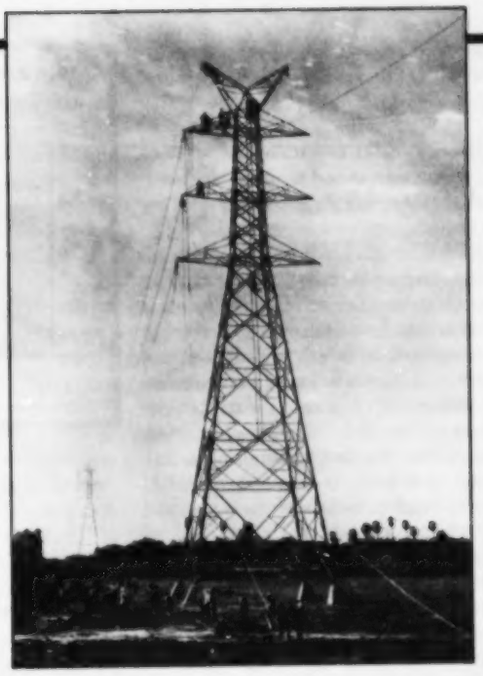


providers often depends on budgetary decisions unrelated to performance and on pricing decisions driven by politics, financial difficulties are common, in particular in power and water utilities (see chart).

• Governments impose overstaffing on infrastructure agencies to create public sector jobs, passing the additional cost on to taxpayers or consumers, most obviously in transport.

But while problems among public providers appear to be the norm in developing countries (see "Infrastructure for Development," in this issue), there are also examples of success: Korea and Singapore in most or all sectors, Mexico and Thailand in power, and Botswana and Togo in water supply (see box). Why do they have an enviable performance record? Because they are run on commercial principles like any successful private organization. More specifically, they enjoy clear and coherent goals focused on delivering services, autonomous management and accountable managers and employees, and financial independence—in an environment that includes competition with appropriate regulation.

These commercial principles come naturally to a private business. But for public sector organizations, they often need to be introduced along with three core instruments: corporatization, explicit contracts, and improved cost recovery.

Corporatization

The first step for many countries in explicitly separating infrastructure providers (e.g., power, ports, railways, telecoms, and water entities) from the government is organizing them as public enterprises rather than government departments. Corporatization is the next step, giving a public enterprise a quasi-independent status and subjecting it to the same legal requirements as private firms—standard commercial and tax law, accounting criteria, competition rules, and labor law.

In practice, however, this transformation is often incomplete, because public organizations do not face adequate competition or do not have solely commercial objectives. For example, corporatization should transfer employees from civil service status to contracts governed by ordinary labor law. Yet even under corporate structures, public entities are often reluctant to reduce employment. Also, it takes time and much effort to convert a government department into a public corporation: it took ten years to corporatize fully Indonesia's major ports. But there are also very quick gains. In Ghana, within two years

How to run a public utility: Botswana

Since 1970, Botswana has been able to provide potable water to the country's principal urban areas and operate a financially self-supporting service—one of the few African countries with a safe urban water supply. Indeed, a World Bank review in 1993 of Botswana's Water Utility Corporation (BWUC) showed that the utility maintains a 24-hour supply of water to all its service areas, with high-quality treatment. Water losses are acceptable, at about 15 percent in the distribution system and 10 percent in the raw-water transmission and treatment processes, reflecting the good quality of BWUC's engineers, who are attracted by competitive salaries.

BWUC charges commercially oriented tariffs appropriate for the urban conditions in Botswana, not hesitating to adjust prices as needed in order to manage demand. Meters are read and consumers are billed monthly, with 30 days to pay. Supply is cut off immediately if payment is not made, and there are charges for reconnection. Accounts receivable are usually less than 2 percent of all the amounts collectible, attesting to the success of strict billing and collection procedures.

A family of six consuming about 100 liters a day per capita pays about $8.85 a month—about 8 percent of its income. Reducing consumption to 80 liters lowers the water bill to about 5 percent of income. A wealthier family consuming twice that much would pay about $22.25 a month. These charges are high compared with those levied by similar African utilities, but they constrain consumption and ensure that the utility does not have to rely on subsidies from the government or other sectors in the economy.

An innovative feature is the "one-check" system for government users. The Ministry of Finance meets all monthly charges for the government and deducts them from the cash allocations of each ministry or department. This procedure avoids the accumulation of arrears by government users of infrastructure services that is common elsewhere.

of the improvement in accounting practices, real operating costs in the state transport corporation were down by 67 percent.

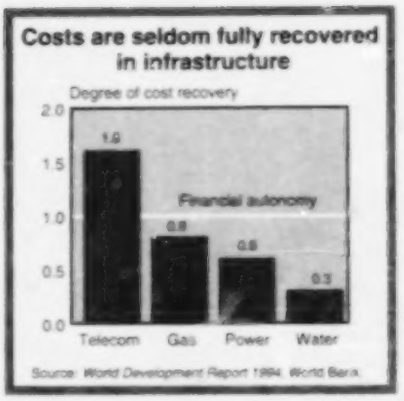
Explicit contracts

Organizational changes alone, however, neither provide clear goals nor create incentives for managers to meet these goals. The introduction of market principles can help, although there are limits to the use of markets and to the value of profit maximization as a goal. Providers have problems in recovering costs directly from beneficiaries of services (as with roads), governments have objectives other than profit, or prices have to be regulated outside the supplying entity (as when providers have monopoly powers). When this happens, three types of explicit contracts—which increase autonomy and accountability—can be called upon.

Performance agreements. These agreements, which retain all decisions in the public sector, are negotiated between the government and public managers. They are aimed at increasing the accountability of employees and managers and improving the focus of operations by clarifying performance expectations and the roles, responsibilities, and rewards of all those involved. They force the development of an information and evaluation system for performance monitoring, including standard financial and cost accounting procedures, and detailed quantitative and qualitative indicators (e.g., for roads, this would include measures of the condition of the network, its use, its management, its productivity, and its financing). The information collected can then be used to build in incentives, whether they be pecuniary bonuses (up to 35 percent of total wages in India, Korea, and Mexico), nonpecuniary rewards (award ceremonies or press coverage), or even sanctions for nonperforming staff.

Performance agreements have been often successful in East Asia, thanks to explicit efforts to build incentives for managers and workers into the contracts and to monitor these incentives. In Africa and in many South American countries, however, they have not been as successful, especially with respect to financial targets because incentives were not built in properly. These difficulties explain why many Latin American governments are increasingly privatizing and why most experts suggest that governments who want to maintain ownership of assets should rely more on the alternatives discussed next.

Management contracts. These contracts—which transfer to private providers the responsibility for managing a utility, usually for three to five years—increase the autonomy of management and reduce the risks of political interference in the day-to-day operations of the public entity. They also serve as interim arrangements allowing private firms and public agencies to gain experience with partnerships before engaging in more comprehensive contracts.



A management contract signed for the power company in Guinea-Bissau is showing that these contracts may work where performance agreements have failed: the new management doubled electricity sales in just three years. The key is to grant the contractor significant autonomy in decisionmaking and relate compensation to performance, such as reduced leakages and increased connections. The contract in Guinea-Bissau specified that 75 percent of the remuneration was guaranteed, but that the remaining 25 percent was based on performance.

Service contracts. These contracts transfer to private suppliers the responsibility for either delivering a specific service at lower costs, or providing expertise that is lacking in the public sector (e.g., design engineering) or too expensive to maintain permanently on public payrolls. The infrastructure supplier sets the performance criteria, evaluates bids from competitive tendering, supervises performance, and pays agreed fees.

Contracting out is most common for maintenance services. Major overhauls of power stations, for example, are routinely contracted out to plant suppliers or specialists in most developing countries. Standard professional services—such as auditing, data processing, and recruitment—are also often contracted out. Catering, cleaning, and ticketing are contracted out in Pakistan's railway. Meter reading and fee collections in water and sanitation have been handled through service contracts in Chile since the 1970s. Santiago's public water company even encouraged staff to leave and compete for service contracts.

Contracting out tends to be more cost-effective than using public employees to handle maintenance (known as "force account"). Brazil's switch to road maintenance by contract reduced costs by some 25 percent for equivalent service quality. Remaining account work groups of the government have also become more efficient since required to compete with private contractors.

Picking the contract. Which of the three types of contracts is the right one depends on the infrastructure activity and the possibilities of contracting services or management out to the private sector. But more important, it depends on the specific cause of poor performance—is the problem with the government, the managers, or the workers?

If the problem is with the government, the performance agreement may be the preferred instrument because these agreements are reciprocal. For instance, they can be used to put pressure on the government to keep its promises to authorize and enforce tariff increases. If the problem is with management, much depends on whether abilities or incentives are in question. Performance agreements with incumbent public managers assume that their capabilities are adequate. Thus, management contracts based on performance are more effective in the short run for organizations with weak management skills. However, for dealing with incentives—and this applies to workers, too—performance agreements need to make a clear link between performance and rewards. Management and service contracts have the added advantage of signaling to civil servants and public managers that if they fail to deliver, there are alternatives in the private sector.

Cost recovery

The third core instrument to successful provision of infrastructure services on a commercial basis is the establishment of reliable revenue sources to ensure the financial autonomy of public agencies. Reliance on revenues directly related to services delivered increases the productivity of suppliers and often benefits users. With fewer budgetary transfers and the freedom to set prices—within the limits defined by regulation—there is less occasion for the government to interfere. Just as important, better cost recovery allows public managers to rely on the price system to assess users' willingness to pay.

Among public utilities in developing countries, gross revenues typically cover costs only in telecommunications (see chart). Even so, local services are usually underpriced, with the losses made up from significantly above-cost charges for long distance and international service. This difference between tariffs and costs is a type of tax on users. In all other sectors, the gap between revenues and costs

implies a government subsidy to users, varying from 20 percent for gas to 70 percent for water. In many of the countries, these subsidies actually benefit the rich more than the poor. In Costa Rica, for example, the richest 20 percent receive 1.3 times as much subsidy for water and sewer services as the poor.

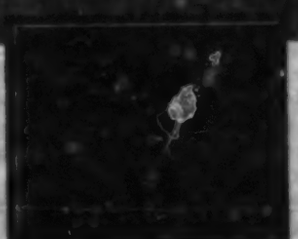
In many countries, the best way of reducing the gap between costs and revenues is to cut costs and achieve productive efficiency. Costs due to poor debt management are excessive in about a third of Bank-supported infrastructure projects. Maintenance problems that cause water or power losses are even more common and costly. In Mexico City at the end of the 1980s, neglect of maintenance and lags between tariff increases and cost increases in the water sector required a federal subsidy of about 0.6 percent of GDP a year.

Once costs are controlled, well-established pricing principles can help achieve financial autonomy and reduce distortions in the allocation of resources. The infrastructure pricing strategy of countries as different as Botswana, Chile, Korea, and Singapore aims at cost recovery sufficient to guarantee the financial independence of public utilities. Their utilities' prices recover the three main cost components of most infrastructure utilities: connection, usage, and peak capacity costs. The cost of connecting a customer and maintaining that connection to distribution or collection networks is typically levied as a periodic flat fee, often linked to charges based on usage in a two-part tariff.

Cost recovery and the poor. Many governments fear that fully recovering costs will hurt the poor, yet increasing prices may actually help the poor. This is true because prices that enable cost recovery in the delivery of services provide the utilities with the resources and the incentive to expand networks to service the areas where the poor live. In the mid-1970s to early 1980s, people in 17 cities were paying private water vendors an average of 25 times the prices charged by public water utilities. In Nouakchott, Mauritania, and Port-au-Prince, Haiti, vendors were charging up to a hundred times the public utility price. Expanding the utilities network to give the poor access would mean that they would pay less than they are now actually paying to private providers.

Political commitment

Reforming the public sector, however, will not work without political support. This is why the commercialization process has to be designed in a way that increases the odds of this occurring. Explicit or implicit contracts between policymakers and managers or operators can be used to define clear rules for performance and force their monitoring and implementation. Service contracts seem to be the most reliable in this respect. Moreover, they test the capacity of the private sector to contribute to the provision of infrastructure. Performance agreements have been the least successful because they can too easily accommodate discretionary decisions driven by the many conflicting or evolving government interests. Pricing strategies can also play a key role: how subsidies are designed and how they are financed are critical to the political viability of a commercialization strategy. ■



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INTERVIEW

New IFC Chief Reflects on Challenges Ahead

Jannik Lindbaek, head of the International Finance Corporation—the private sector arm of the World Bank Group—shares with Finance and Development ***his views on how the institution can meet the challenge of fostering private sector development in today's rapidly changing, high-risk international financial environment.***

IFC's role

As IFC approaches its 40th anniversary, it is growing fast and it is profitable. What exactly do you see as IFC's role?

The IFC's main role will always be a catalytic one. The needs of developing countries will always far outstrip the resources that IFC can bring to the market. This means that we have to try to mobilize funds from sources other than ourselves, both by attracting financing for individual projects and by developing local capital markets.

We are seeing a unique situation in that the demand for our services is at a record level. The move to more market-based productive activity worldwide has driven this increase in demand. IFC's dramatic growth in investment activities, capital markets development, and advisory services in recent years is a reflection of this new reality. On the other hand, I firmly believe that a financial organization should have "organic growth"—you cannot grow in steps; you have to build the portfolio over time or you risk making costly mistakes. We are undergoing substantial growth, and I expect that to continue in the near future. But this also presents a challenge: ensuring that growth takes place efficiently and productively.

The World Bank is planning to do a lot more in the private sector. How do you see cooperation between the Bank and IFC?

In one sense, there is a clear distinction between Bank and IFC lending in that the Bank always has to have a government guarantee whereas IFC is not allowed to accept government guarantees. Beyond this, traditionally, the role of the Bank in private sector development has been more policy-based whereas IFC is transaction-oriented. Recently, however, as IFC's activities have increased in certain sectors, IFC has provided more input on policy, and the Bank has become more involved in private sector transactions. This is both unavoidable and desirable. Joint Bank/IFC work has been strong in areas like infrastructure, particularly power and telecommunications, and capital markets development. I am fully on the record as being in favor of strengthening Bank/IFC cooperation.

Assuming a project or enterprise is likely to be profitable, what does IFC provide that investment or commercial banks do not?

We can provide a degree of political comfort, which a private institution can never give. Our relationship with governments provides some reassurance to other investors that the local government is supportive of the project. That is quite an important consideration. The political situation in some countries is very difficult and, as a result, there are almost no private flows to some areas. Our process of scrutinizing projects and carefully analyzing all aspects, not only commercial but technical, developmental, and environmental, to name a few, is not undertaken to the same extent, if at all, by private financial institutions. IFC brings something additional to the table as a result of such analysis. We can help structure projects to limit risk.

Which investment areas will be key for IFC in the coming years?

One area is infrastructure. Five years ago, the approvals were still small. This year, they are up to about 25 percent of our total. So it is a very rapidly growing area, reflecting the great change in the market for infrastructure finance, where so much has moved from the public sector to the private sector. We will also continue to emphasize our capital markets work, given the fundamental importance of capital markets as a building block for private sector development.

But according to the Bank's World Development Report 1994, ***about 90 percent of financial flows for infrastructure in developing countries are still provided directly or indirectly through government agencies. What is the growth potential?***

The public sector will always play an important role, but the shift in many parts of the world, notably in Latin America and in the Far East, is one of the strongest trends that we are seeing in the market at the moment. Resource requirements are so great that governments are beginning to recognize that they cannot do it all and are encouraging the private sector to step in. I see a unique position for IFC, not only in helping to arrange long-term financing, but also along with others, in providing the necessary equity financing and technical advice.

Would you highlight any particular area within the infrastructure sector where you expect growth to be the strongest?

Power production, because this is such a bottleneck for many developing countries in terms

of unleashing their industrial potential. Another important area is telecommunications. Here we are not only talking about traditional developing countries but also Central and Eastern Europe, where the markets are very big indeed. It is an area where IFC is eminently well-placed to play an important role as we have relationships with all the major players.

What will IFC do to push private infrastructure financing in those countries that so far have received little of it?

We are already working on providing governments, through technical assistance and other means, with advice on how to structure contractual and legal arrangements to foster private investment. We are also promoting a number of power production projects in low-income countries. Here, our role can be crucial because some of these countries do not have the credit standing that is necessary to arrange traditional financing.

IFC's financial position

With the role of the private sector now at the forefront of the development agenda, will IFC be in an adequate financial position to respond to the growing demand?

On the external front, the speed of change is great. Private capital flows to developing countries are at record levels. On the internal front, IFC has limited capital and we would have faced severe headroom problems in a few years if nothing had been done about it. We have been able to address those needs through the introduction of new financial policies based on the Bank for International Settlements capital adequacy framework. This, coupled with other measures, will allow us to continue to grow at the present rate through the end of the decade. We are also considering securitizing part of our loan portfolio to enhance our capital. The pilot transaction that we are now considering is, tentatively, about $400 million dollars.

Even with a continued growth of 12 percent annually—your base case rate—IFC is not likely to be able to meet the growing demand. This puts a premium on leveraging resources to the maximum extent possible and undertaking other activities. How is IFC responding to this challenge?

There is no reasonable rate of growth which would allow IFC to fully meet the demand for our resources. That has never been our objective. The average mobilization rate for IFC last year, that is, how much money we generate from other sources in support of our projects, was 6:1. But with strong growth in infrastructure and natural resource projects, which have higher mobilization ratios, we expect this average to increase. But we should not underestimate the impact of our recent and anticipated growth: the 12 percent growth in our three-year plan is identical with a doubling every six years. Our approvals have increased from roughly $1 billion per year five years ago to about $2.5 billion today, and we should be close to the $5 billion mark by the end of the century.

Before your predecessor stepped down, he called for more money to go to IFC from the World Bank, a call that is also heard from outside critics of the Bank. The Bretton Woods Commission has urged the Bank to expand IFC's capital by assigning additional resources out of its income or reserves, or by lending to IFC. How do you feel?

It is a fact that IFC is growing very fast and I think that growth will continue for the near future, certainly the rest of this decade. It is also a fact that the World Bank is not currently in a strong growth phase in volume terms, but even so, there is a great deal of difference in size between the two institutions. IFC has resolved its most pressing problems with regards to capital, so there is no immediate need for further capitalization or a transfer of capital from the Bank to IFC. But if we are required to meet an even larger share of the demand than we have anticipated, the capital requirements of IFC would have to be addressed.

So far, IFC has been a big investor in equities. Do you feel the emerging markets in equities have peaked?

No, I do not believe that the emerging markets have peaked. However, we did identify the possibility for a correction in the emerging markets in the past fiscal year and took steps to sell more of our mature equity portfolio than originally planned. So the correction did not come entirely as a surprise—in a way—it was overdue. After all, the emerging equity markets had a tremendous performance in the last two to three years. For the long term, I am optimistic, although we may not see, on a relative scale, quite as strong a growth as in the last three years. I think the emerging markets will, over the next five to ten years, outperform the more mature markets.

How does IFC balance its development role with its mandate to return a profit on its investments?

In the individual project, these two things are possible to reconcile because the only project that really benefits a country is a viable project—and a viable project is by definition a profitable project. In fact, being profitable has a strong demonstration impact for other potential investors and is central to our objective to build a strong private sector in developing countries. But what we are talking about in broader terms is the need for IFC to be profitable. And that is quite a challenge, in that we have a very limited area of operation. We only do private sector projects in developing countries, which is a limited niche entailing many elements of risk. In accordance with our development role, we take risks every day in countries where many banks do not normally lend. Further, in order to finance our projects with long-term finance, we need to borrow with an AAA rating, which in turn requires maintaining acceptable profitability. Maximizing profitability will never be IFC's goal, but we must have acceptable and stable profitability.

Privatization efforts

What lessons has IFC learned from its extensive privatization work in Russia?

Privatization in itself is not an end, but it is a means to achieve a goal, and the goal is the transition of command economies to market-based economies. What we have tried to do is help develop mechanisms and methods for privatizing various parts of the economy—methods that could be replicated internally. The experience that we have seen so far is quite remarkable. Taking the case of Russia, trying to assist that country in moving from a

command economy to a democracy and a private sector economy within a few years is perhaps an unrealistic task. We have instead tried to focus on smaller, manageable efforts aimed at specific niches where there is maximum potential for a demonstration impact and replication in other cities and regions.

Any particular examples?

What I find fascinating is the privatization of agricultural land. There is strong agricultural growth potential, but the way agriculture was organized in the former Soviet Union was a major obstacle to the performance of this sector.

The land privatization program has been structured so that those that will own and farm the land have the right to choose how the enterprise will be organized. The whole process, including an auction, is as open and transparent as possible. We have just completed the third privatization of state farms in Russia, and we have written the manual, both in English and Russian, on the method. Originally, Mr. Chernomyrdin, the Prime Minister, was skeptical concerning the privatization effort in agriculture, but today, he is a strong proponent of privatization under the IFC plan—endorsing it as a standard for the whole of Russia.

In the rush to privatize to mobilize revenue, some countries are leaving monopolies in place with little or no price regulation. Do public monopolies behave any better than private monopolies?

Not necessarily. Where we have cooperated in privatizations, we have always tried to see to it that there are at least two parties and that there is competition—that is absolutely essential.

New countries

How is IFC approaching work in the emerging markets of South Africa, Viet Nam, and the West Bank and Gaza?

Now that we have seen an orderly election process in South Africa, there will clearly be a role for IFC. But it is somewhat different from the role that we have been playing in other parts of Africa, as South Africa is a developed economy with a functioning capital market. In essence, we shall try to help "bridge the gap" between the developed and the less developed parts of the South African economy. First, the country needs a capital market to encompass the whole population to a greater extent than is the case today. Second, we should try to help in projects where we can effect the transition of ownership to other parts of the population. Third, there is a lot of work to be done in assisting and financing small- to medium-scale enterprises. We shall be opening an office in South Africa, jointly with the World Bank, fairly soon.

As for Viet Nam, our first project is the modernization and refurbishment of one of the hotels, and we have three or four more projects on the drawing board, including a small port. We are also looking at the possibility of creating investment funds, and have advised the Vietnamese Government on the development of financial markets and a leasing industry.

Highlights of Jannik Lindback's career

- Became IFC Executive Vice President in 1994, replacing Sir William Ryrie, who retired on December 31, 1993.
- President and Chief Executive Officer of the Nordic Investment Bank, 1986–1993.
- Group President and Chief Executive Officer of the Storebrand Insurance Group, Norway's largest insurance company, 1976–85.
- Served on the boards of several companies, including *Aftenposten*, Norway's leading daily newspaper; Capital Markets Insurance Corporation (New York); Vesta Insurance Company; and Det Norske Luftafartselskap (the Norwegian partner in SAS).

Regarding the West Bank and Gaza, we have already gone to our Executive Board with the first project—the Arab Palestine Investment Bank created jointly with the Arab Bank Group of Jordan. It is a private sector bank and the intention is to provide long-term finance for private sector projects.

Will the bank be under the new Palestinian Monetary Authority or Jordanian banking law?

The Bank of Jordan is our major sponsor and also the majority partner.

Which currencies will be used?

Both the Israeli shekel and the Jordanian dinar will be acceptable.

How about currency risk?

The lending will probably take place in multiple currencies, so we will not be exposing ourselves to currency risks.

There are vast amounts of Palestinian capital abroad—and other potential capital—but apart from repatriating savings, this capital is apparently staying abroad until the strategic uncertainty is resolved. What difference can IFC make?

One of the ways that we can channel funds into the West Bank and Gaza is by creating various types of investment funds. We are reasonably confident that one or more of these funds will be off the ground soon. Here again we can play a catalytic role, and under the IFC umbrella bring in many other investors who would otherwise be reluctant or unwilling to come in on their own. For the longer run, the role for IFC will be in infrastructure, and as stabilization takes effect, tourism.

The environment

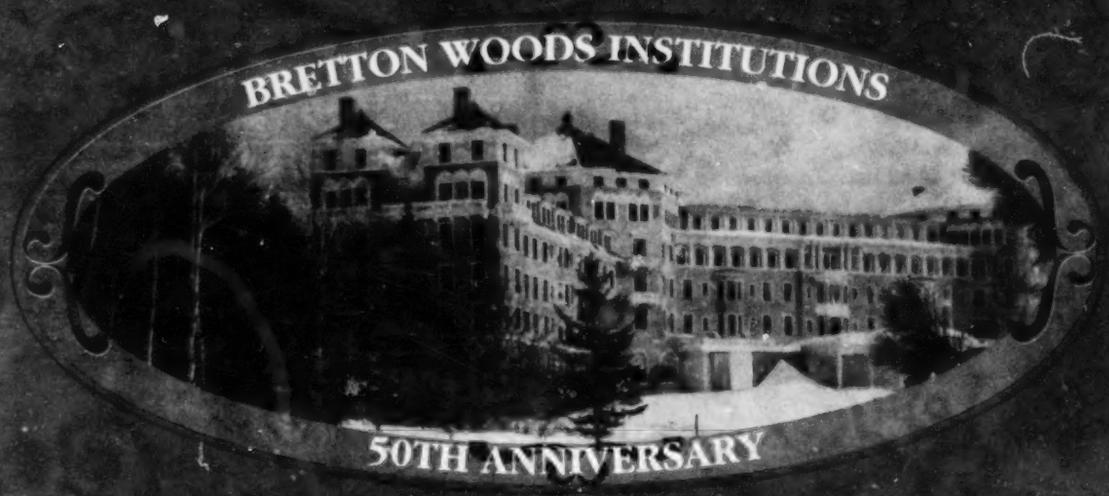
How can IFC ensure that its investments are environmentally sound?

It is our policy to only finance projects which are environmentally sound. We have recently strengthened our procedures to ensure that due regard is paid to environmental issues in IFC-financed projects. This strengthened approach includes requiring thorough environmental assessments for the most environmentally sensitive projects and comprehensive public consultation programs with local populations who may be affected by the project. More recently, we have established a new policy on disclosure of information which we think strikes the right balance between our public duty to be as transparent as possible in our operations and the need to protect the confidentiality of our clients.

As head of the Nordic Investment Bank, you set up the Nordic Environmental Finance Corporation. How do you see IFC's involvement in the environmental services sector? Will IFC's recent decision to invest in a wastewater treatment plant in Puerto Vallarta, Mexico, be just the beginning?

IFC is committed to giving special support to environmental projects. The private environmental sector is taking off not only in the developed world but in developing economies as well. In this respect, a dollar spent on the environment in developing countries tends to have a far more dramatic impact in terms of pollution abatement than does the same money spent in the developed world, which yields more incremental improvements. For example, when you have raw sewage being pumped into rivers, even a primary sewage treatment facility can make a huge difference in water quality. So the potential here is large. We have, in addition to the project you pointed out in Mexico, also invested in water supply and treatment in Argentina. We think this is only the beginning and have been undertaking an active environmental investment identification effort to locate suitable projects and sponsors in this sector. When we find such projects, we will invest. ■

Laura Wallace, Senior Editor, interviewed Mr. Lindback.



The world economy has evolved enormously since the World Bank and the IMF were conceived at the Bretton Woods conference in July 1944. There have been many challenges: rebuilding Western Europe after World War II, and more generally, fostering development worldwide; the abandonment of the Bretton Woods par value system in the 1970s; the debt crisis of the 1980s; and greater volatility of the major currencies in the 1990s, to name but a few. At the same time, much has been achieved: living standards have improved in most countries; goods and capital markets have become much more integrated, thereby providing developed and developing countries alike with greater opportunities for economic growth; and the formerly centrally planned economies are being reintegrated into the world market economic system.

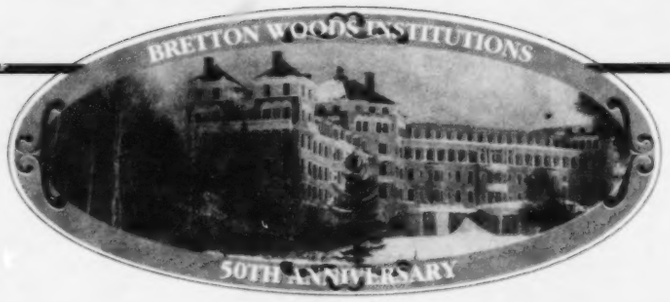
The Bank and the IMF have played an important role in these developments by fulfilling their original mandates—to foster long-term economic growth and development, and to oversee the international monetary system and facilitate economic cooperation—and also by showing great flexibility in adapting to the rapidly changing international economic environment.

The 50th anniversary of the founding of the Bank and the IMF provides an opportunity to learn from the past, and also a chance to look forward to the challenges that may face the two institutions in the next century. The articles included in this supplement examine how the policies of the Bank and the IMF might evolve to meet those challenges.

For the IMF, the main issues touch on its role in the international policy coordination process—its surveillance role; whether its resources are adequate to address the potential financing needs of an expanded membership in a world of large and volatile capital movements; whether lending policies should encompass longer-term development issues; and how much emphasis should be given to social and environmental issues in IMF-supported adjustment programs. These issues have been, and no doubt will continue to be, actively debated in the IMF's Executive Board.

In the World Bank, the institution's fundamental objective of helping borrowers reduce poverty and improve living standards is being pursued in new ways. The themes of fostering broad-based growth, human resource development, environmental sustainability, and private sector development—which are essential to reduce poverty—are being given high priority. Steps are also being taken to improve business processes, to assure availability of appropriate technical skills, and to increase involvement of all key people and institutions in the development decisions that affect them.

The continued effectiveness of the Bank and the IMF depends vitally on their ability to move in step with the times. The momentum for change imparted by the rapid evolution of the world economy should help to make the two institutions even more efficient and responsive to the needs of their member countries.



Poverty Reduction: Learning the Lessons of Experience

SVEN SANDSTRÖM

"BUT FOR those less fortunate, freedom means little when it is freedom only to live out their lives in misery and want...If during the last hundred years, greater effort had been devoted towards improving conditions in the less developed areas of the world, we might not today be witnessing so much social unrest and possibly not even hostilities. I suggest that it is the existence of widespread poverty and misery which has stimulated the spread of the virus now threatening the peace of the world."

These words were spoken in 1950 by then-president of the World Bank, Eugene Black. They give an indication of the institution's enduring concern with the reduction of global poverty. What are the major lessons that the Bank has learned about fighting poverty over the years—and how is it applying them?

The past 50 years have seen a significant improvement in the lives of people in the developing world: life expectancy has increased by 50 percent; infant and child death rates have been cut in half; the proportion of children starting school has risen from less than half to more than three quarters—despite a doubling of population; and the percentage of rural families with access to safe water has risen from less than 10 percent to almost 60 percent. In the past 25 years alone, average per capita incomes in the developing world have doubled—a feat that took the United States nearly 40 years (1913–50), Canada 42 years (1913–55), and the United Kingdom 60 years (1780–1840) to achieve during their rise to industrial maturity. The past generation has seen more rapid development progress than any comparable period in human history.

The Bank has contributed to this progress by supporting more than 5,000 development projects in over 140 countries, and by lending more than $300 billion. The institution has learned from this experience and has translated the knowledge gained into improved policies and improved projects.

Yet, despite this progress, poverty remains the greatest challenge facing the world today. More than a billion people still struggle to survive on less than a dollar a day. Child mortality rates in the developing countries are still ten times higher than in the developed countries. Seven million people still die every year from easily preventable diseases. And the income gap between rich and poor countries is still widening: over the past 30 years, incomes in the countries with the richest 20 percent of world population grew nearly three times faster than in those countries with the poorest 20 percent.

In the 1950s and 1960s, the Bank—as did most others—thought that the best way to reduce poverty was through investment in infrastructure and rapid industrialization. In the 1970s, the focus was on poverty reduction through support for integrated rural development and urban projects. In the early 1980s, in the face of widespread macroeconomic and debt difficulties, the Bank emphasized policy frameworks aimed at restoring growth. And in the late 1980s, it began to highlight the importance of environmental protection and the role of women in the fight against poverty.

The *World Development Report 1990 (WDR)* on poverty sought to distill these decades of experience and point the way toward a comprehensive poverty-reduction strategy that incorporated and balanced these various emphases. Several general lessons

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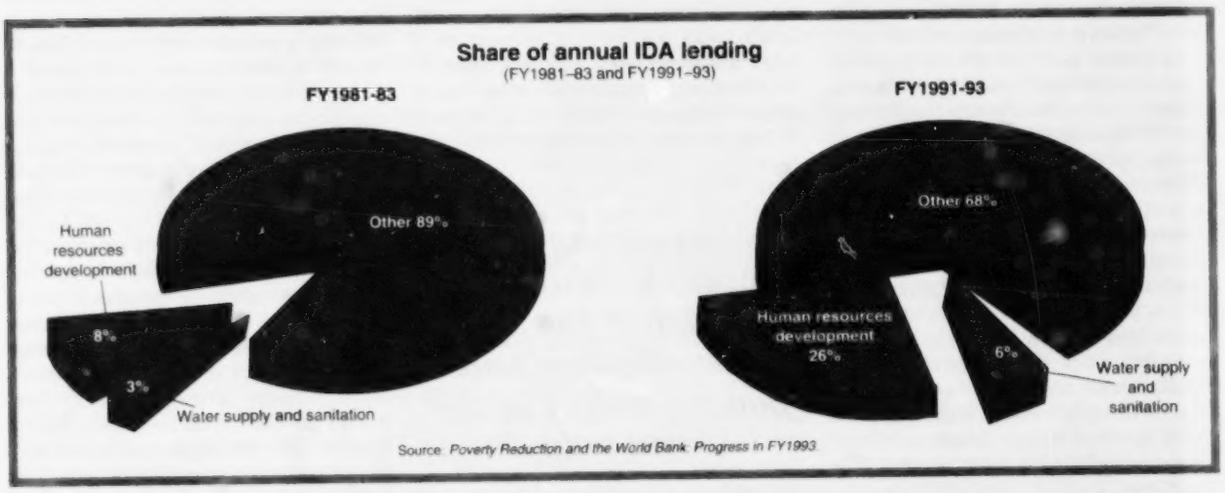

Source: *Poverty Reduction and the World Bank: Progress in FY1993*.

were clear: people must be at the center of any strategy, as both the means and the ends of poverty reduction; policies that reduce as much poverty as possible as quickly as possible were crucial; poverty reduction programs should be tailored to the different needs of different nations; the influence of the international economic environment—aid, trade and debt strategies—on the pace of progress in reducing poverty had to be taken into account; and—one of the most important lessons—poverty cannot be conceptualized as just another "sector" or area of emphasis. On the contrary, poverty reduction must be the central focus of, and integrated into all development work. It must be placed up front as the central objective which determines policies and investments.

Ten key lessons

Beyond these broad points, the Bank's work suggests 10 lessons that have been learned and are being applied increasingly in the institution's approach to poverty reduction:

A two-track strategy. The strategic framework to reduce poverty must consist of two central, mutually reinforcing elements: (1) economic growth and (2) investment in people. One without the other is not enough—as highlighted by the *WDR 1990*.

No country has managed to reduce poverty on a long-term basis without sustained economic growth. However, the pattern of growth is as important as the rate of growth. Labor-intensive growth allows the poor to make use of their major asset—their labor. It provides jobs and boosts incomes for the poor. A "market-oriented" approach, which strikes the right balance between the roles of the public and private sectors, has proven to be the most effective way of achieving this kind of growth. Only the private sector can create the large number of jobs that are required to bring about sustained, poverty-reducing growth.

The East Asian countries that have achieved high rates of poverty reduction have pursued this pattern of growth, emphasizing broad-based agricultural development and labor-intensive industry (see: "The East Asian Miracle," *Finance & Development*, March 1994). Between 1970 and 1990, East Asian countries reduced the incidence of absolute poverty from 30 percent to 10 percent, or by 1 percentage point a year for 20 years. These countries can serve as an example for others. Even though it may not be possible to replicate all of the elements of their success, their experience illustrates that the pattern of growth is important and that policies should allow the incomes of the poor to grow faster than average incomes.

Through policy dialogue and support for adjustment, the Bank is focusing increasingly on measures at the macroeconomic and sectoral level that are both pro-growth and pro-poor. These include: freeing the price of agricultural products to benefit small farmers; removing anti-employment biases—such as restrictions on labor mobility and the subsidization of capital—to increase job opportunities; and promoting economic stability—inflation, for example, is a regressive tax which hurts the poor. These kinds of poverty-reducing policies are the first step toward a pattern of growth that explicitly favors the poor, but they are only the first step.

Investment in people is just as important as growth. The availability of good quality education, health, nutrition, and family planning are essential to enable the poor to contribute to and participate in growth. The compelling appeal of social development is that, as well as improving human welfare directly, it is a sound economic investment. Experience indicates, for example, that no country has been able to take off economically with a literacy rate of less than 50 percent.

Again, the East Asian countries have pointed the way. They have struck a very effective balance between rapid growth and investment in people. For example, East Asia began its rapid growth with an educational advantage over other developing economies and sustained that advantage through explicit policies of investment in basic education. Public spending concentrated on primary and secondary education, while the limited public funding for postsecondary education was used primarily for science and technological education. Moreover, declining fertility and rapid economic growth meant that even when education investment as a share of GDP remained constant, more resources were available per child in East Asia than in other developing regions.

Reflecting these lessons, the Bank's lending for human resource development has increased substantially over the years, tripling in the last decade, from 5 percent of total lending in 1981–83 to 15 percent in 1991–93, and reached $3 billion in fiscal year 1993. Its lend-

ing to the poorest countries (International Development Association) went from 8 percent in 1981–83 to 26 percent in 1991–93 (see chart). The Bank's policy dialogue with its borrowers also now emphasizes issues such as restructuring public expenditure in support of human resource development.

Targeting and safety nets. Increasing social expenditures is essential for poverty reduction, but it is not enough. The efficiency and effectiveness of those expenditures is equally important. Careful targeting of scarce resources to ensure that they reach those most in need is imperative. In-depth studies of poverty alleviation programs in Malaysia and Indonesia, for example, show that the poor benefit most from the broad targeting of basic services such as primary schools and health centers. More narrowly targeted programs can help reach particularly vulnerable groups. Among these are health and nutrition schemes for mothers and infants; feeding programs for the victims of drought or famine; safety nets for the sick, the old, and the newly unemployed.

These issues were not given sufficient attention during the "first generation" of adjustment programs, but the lesson has been learned. Since the late 1980s, Bank-supported adjustment operations have included the provision of safety nets and social funds for vulnerable groups in many countries—the programs in Bolivia, Honduras, and Zambia provide good examples. In addition, more than 25 percent of total Bank lending in fiscal year 1993 supported specific, targeted programs aimed at poverty reduction—for instance, water and sanitation for low-income communities in China; endemic disease control in Venezuela; and emergency drought relief in Kenya. These are an important complement to other Bank operations and enhance the effectiveness of the overall effort to reduce poverty.

Environmental sustainability. The *WDR 1992* brought home the lesson that for poverty reduction to be lasting, it must be environmentally sustainable. The most common environmental problems hit the poor hardest—dirty water, inadequate sanitation, and soil erosion. The very poor, struggling at the edge of subsistence, cannot afford to make natural resource investments that give positive returns only after a number of years. This means that the poor have little choice but to overexploit any available natural resource.

These problems can be effectively addressed only by building upon the "win-win" links between growth, poverty reduction, and environmental protection. Policymakers should make sure that macroeconomic policies aim to reduce poverty—higher incomes will enable the poor to consider longer range options for resource use that give better returns. Policies should also aim to reduce economic risks for the poor—temporary food-for-work programs during droughts can bring immediate benefits by minimizing natural resource "mining" by poor rural households during crises that threaten to push them below subsistence levels. Improving access to services and infrastructure is another way to reduce environmental problems confronting the poor. Moreover, better access to education, health, and family planning becomes even more important when environmental considerations are taken into account.

"Improving girls' access to education is probably the single most effective anti-poverty policy in the world today."

The integration of environmental concerns into the Bank's operations has become one of the hallmarks of its work in the 1990s. Lending for environmental purposes is currently the fastest-growing segment of the Bank's portfolio—$2 billion in fiscal year 1993 (five times what it was five years ago); Bank-financed projects now include an up-front environmental assessment; and the Bank is assisting its low-income member countries to prepare National Environmental Action Plans that aim to guide policies toward environmentally sustainable development. The Bank is also playing a leading role in the Global Environment Facility, recently restructured and replenished at a level of about $2 billion over the next three years (see: "The New Global Environment Facility," *Finance & Development*, June 1994). The fundamental lesson is that reducing poverty requires protecting the environment and, equally, protecting the environment requires growth and poverty reduction.

Population. Reducing the rapid rate of population growth in many developing countries is important for environmental sustainability and for poverty reduction. Global population will increase more during the 1990s than in any previous decade—by about 850 million people. Ninety percent of this increase will take place in the developing world. In some of the poorest countries—in Sub-Saharan Africa, for example—the population will double in 20 years if growth rates remain at current levels. In short, population growth is running ahead of economic growth. The population issue cannot be addressed effectively in isolation from the overall issue of social development. Experience shows that as incomes rise and people lead longer, healthier lives, fertility declines. Evidence also suggests that narrowly targeted family planning has minimal effect if the vast majority of people in a country remain unhealthy, uneducated, and unemployed.

Since the Bank's first loan for population programs ($2 million to Jamaica in 1970), it has steadily increased the size and scope of its support—about 60 population projects are currently being implemented in over 40 countries. Cumulative lending now totals roughly $1 billion, thus making the Bank one of the largest external providers of aid for family planning. Since the mid-1980s alone, annual Bank lending for population programs has more than doubled ($180 million in fiscal year 1993). These direct commitments for family planning should be seen within the context of overall increasing support for the social sectors and overall country assistance strategies that have poverty reduction as their focal point.

Role of women. The fundamental role of women in reducing poverty is one of the most profound lessons of development experience over the last generation. In most developing countries, women play the major role as producers of food and protectors of the environment and in educating children and nurturing families. They make up a quarter of the work force in industry and a third in services. Yet, for many years, women were treated as "invisible" by governments and development institutions. Consequently, the worldwide progress in social and economic development over the last three decades has not translated into proportional gains for women. Investing proportionally more in women now, therefore, is a crucial element of the effort to reduce poverty more effectively. Improving girls' access to education is probably the single most effective anti-poverty policy in the world today.

Almost 50 percent of Bank-supported projects in fiscal year 1993 had components aimed specifically at including and benefiting women, up from only 10 percent five years ago. Of the nearly $2 billion that the Bank channeled to education in fiscal year 1993, much was focused on getting girls into school. But still more needs to be done. The Bank's recent (and first) policy paper on the role of women ("Enhancing Women's Participation In Economic Development," August 1994) recommends actions that should be taken at both the

project and policy level to reduce gender bias. Evidence of what works is especially strong in five areas: education; health; wages; agriculture and natural resource management; and financial services. The paper also suggests a broadening of the traditional "women in development" approach toward a "gender and development" strategy that takes into account the relative roles and responsibilities of both men and women.

Participation. The global trend toward increased participation is one of the fundamental changes of our time: more open economies and trading systems; more open political systems and democratization; more highly educated people in the developing countries and increasing human-resource capacity; more rapid and widespread forms of communication and information flow. Participation is an important end in itself, but it is also a means to more effective poverty reduction.

A growing body of research is confirming that improving participation can be highly effective in helping communities overcome the shortcomings of very different kinds of economic and governance systems. Participation involves time, financial, and other transaction costs. The costs of not involving key participants, however, can be even higher—in terms of the sustainability of projects and programs. This is most apparent in the social sectors. However, it is no less true in the "harder" sectors—infrastructure or energy, for example—where involving a broad spectrum of interests is vital. A participatory approach benefits all development activity and—though at different points on the learning curve—all development institutions now recognize it.

The Bank has learned a good deal about participation—through its experience with rural/urban development and water/sanitation projects, for example. For many years, not enough was done to focus and apply the lessons. This began to change in the early 1990s with the establishment of a "learning group" on participation within the Bank and an increasing trend toward a participatory approach. A new generation of projects has begun to emerge: the Matruh Natural Resource Project in Egypt, the Chad Education Project, and the Water and Sanitation Project in Brazil, all involving local communities from design through to implementation. More significantly perhaps, there is an increasing trend towards participation in the formulation of country assistance strategies and in economic and sector work, thus applying participatory approaches at the policy level, where they can have maximum impact.

Governance. It is primarily a government's responsibility to involve its citizens in the development decisions that affect their lives. Governments also have a responsibility to ensure accountability and transparency for their actions if resources are to have maximum impact in benefiting the poor. Corruption and excessive military spending, for example, divert attention and resources from the poor.

In the 1990s, the Bank has attached increasing importance to helping its borrowers strengthen their governance systems. This involves a variety of approaches: support for improving public institutions; civil service reform; public expenditure reviews; improvements in legal and accounting frameworks; and assistance with military demobilization (as in Uganda and Mozambique). Consistent with the Bank's Articles of Agreement, this work has concentrated on the economic dimensions of governance. In the process, it has increased the potential for more effective poverty reduction.

Knowledge. Improved knowledge and measurement of poverty increases the potential for greater effectiveness of poverty reduction strategies. In recent years, the Bank and its borrowers have undertaken about 80 poverty assessments. These address three basic questions: Who is poor? Why are they poor? What needs to be done to reduce the number of poor? Assessments then form the basis of action plans that are integrated into country assistance strategies. In China, for example, the poverty assessment found that the poor are now essentially concentrated in resource-deficient parts of the interior provinces—thus requiring a carefully "targeted" anti-poverty program. In India, by contrast, the assessment concluded that more "broad" structural reforms are needed to promote growth and stimulate labor demand. These poverty assessments and other new sources of knowledge are enabling the Bank and its clients to focus on specific poverty issues in specific country circumstances. Furthermore, by sharing this knowledge with its partners, the Bank can help to build a more coordinated approach to poverty reduction on a country-by-country basis.

Partnership. Strengthening coordination and partnerships, among developing-country governments, the private sector, nongovernmental organizations (NGOs), bilateral donors, the UN system and the Bretton Woods institutions, is critical for more effective poverty reduction. Increasingly, the Bank has been expanding collaboration with its partners—the Special Program of Assistance for Africa, the Global Environment Facility, the Consultative Group on International Agricultural Research, country consultative groups, numerous joint operations with the regional development banks are examples. NGOs too, are now involved in about a third of all Bank-financed projects (50 percent in Africa). But even greater efforts must be made to work out a more effective division of labor among the various bodies engaged in poverty reduction. The Bank certainly does not have all the answers or all the resources—nor does any other single institution.

Implementation. The final lesson is a simple one: it is results that count. There are all too many examples of sensible policies and programs that have not been followed through with sufficient vigor to make the needed impact. We know enough now about the basic strategy to reduce poverty. Implementation must be accelerated and, at the same time, expectations must be realistic. Poverty reduction requires hard work and patience. The East Asian "miracle," for example, did not happen overnight. Rather, it took decades of perseverance and continued emphasis on the two tracks of the poverty-reduction strategy: sustained growth and investment in people.

In recent years, the Bank has taken a number of steps to improve the implementation of its own operations—more emphasis on the quality of initial project design, increased supervision, country management of the portfolio, restructuring of projects—aimed at improving their development impact. To complement the changes in its own policies and practices, the Bank is collaborating with its borrowers to ensure on-the-ground results in reducing poverty.

Conclusion

Experience has guided the evolution of the Bank's approach to poverty reduction. The strategy must continue to evolve in the light of new experience—the emerging challenge of poverty in Eastern Europe must be met, for example. The increasingly rapid pace of globalization—the integration of capital markets, trade, and technologies—will also affect, and be affected by, the pace of poverty reduction. The poorer countries can benefit by adopting policies that will enable them to attract investments and to compete in the global economy. The richer countries will also benefit, through expanding exports and jobs, by supporting programs aimed at sustainable growth and poverty reduction in the developing world.

The challenge for the Bank in the coming years is to maintain and sharpen its focus on poverty reduction, while adapting to global change. All development institutions, including the Bank, need to continue to build upon lessons learned and adapt their approaches to take advantage of these new opportunities and to meet the enduring challenge of poverty. ■

Agility in the New World Economy

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IN THIS NEW, high-speed global economy, agility is a recurrent theme. And because governments are not known for their speed and flexibility, they are turning to entrepreneurs to make their economies more responsive.

The spectacular transformation of the East Asian economies gives hope to everybody involved with economic development. But the persistent stagnation and decline of the poorest economies—and many of the transitional economies—are cause for concern. Unless the private sector is unleashed in today's radically different world economy, countries will continue to diverge—some of them dynamic and integrated with the world economy and others static and left out.

What is different in the world economy? It is now truly global because of a cluster of innovations in telecommunications and information technology. American companies have their telephone inquiries handled by operators in the Caribbean. Swiss Air has some of its accounting done in New Delhi. Time and distance shrink a little more every year. Competing in the new world economy thus calls for greater speed and responsiveness. And because there are limits to what the public sector can do alone, there is an increasing appreciation of the critical role of private initiative in seizing changing opportunities and spurring growth.

Faster growth helps the poor by creating jobs—increasing their productivity and expanding their access to credit, to infrastructure, and to productive inputs. Encouraging private initiative also gives governments the fiscal breathing space to focus on what they do best. By divesting themselves of activities that entrepreneurs could do as well or better, governments can stop draining resources that can be used instead for such services as those in health and education, the best equalizers of income. They can also do more to target assistance for the poor and to establish social safety nets.

Unleashing the private sector

What are the requirements for efficient private growth and what can governments do to bring this about? They can open their economies to trade, investment, and technology; improve the business environment; and help build strong financial systems.

Opening to trade, investment, and technology. Trade, and the competition it incites, provides stimulation for the efficiency of business. And with greater market access to world trade under the Uruguay Round, developing economies' incomes could rise by more than $80 billion.

One of the benefits of trade and foreign investment is the technology that comes with them. The East Asian tigers got much of their technology from foreign buyers and suppliers, precluding the need for expensive (and often duplicative) research and development (R&D). The OECD countries put $400 billion a year into R&D, 25 times what the developing countries invest. The best way for developing countries to upgrade their technology is to strengthen their links to industrial countries and to provide technical education.

Improving the business environment. In developing an attractive business environment in today's competitive world, the focus is on developing competent legal, regulatory, and institutional arrangements that approach or meet international standards of agility and professionalism.

In legal reform, particularly important for private sector development are contract law, labor law, and property rights. Businesses must be free to start up and shut down and to make enforceable contracts. Banks need clearly defined property as collateral, and the right to repossess and sell that collateral quickly in the event of default. Labor laws can hinder—or ease—the entry and exit of firms and their access to credit. And clear property rights are essential for the development of land, the transfer of technology, and the protection of intellectual property.

In regulatory reform, competition is the key. The gains from private sector development come from having firms compete with each other. This means eliminating nontariff barriers, reducing tariffs, eliminating price controls, breaking up monopolies and deregulating foreign investors in ways that fuel competition. For monopolies, especially those in infrastructure, the key is to isolate the monopoly element (such as transmission in electric power) and then to regulate in a way that is consistent with the country's market structure and institutional capacity. Chile and Argentina, for example, have gone farthest in unbundling utilities and attracting private investment.

But legal and regulatory reforms must be accompanied by broader improvements in public administration. Investors are put off by a tax system that is arbitrary and capricious and by a customs clearance system that is cumbersome. Compare Singapore, which clears a shipment through customs in 15 minutes, with Bogota, which can take up to three days to clear outgoing air shipments of fresh cut flowers. Also important for the business environment is the promotion of government-business partnerships that facilitate joint work by governments, institutions, agencies, and businesses.

Improving the business environment in the countries of Eastern Europe and the former Soviet Union is a severe challenge because they must create a modern private sector

"from scratch." In many such countries, a stable and known set of rules—for investment, taxation, and land ownership—is only beginning to emerge, while the underlying legal frameworks are unsuited to the needs of a market economy. The obstacles to improving the business environment in these economies are rooted deep and not susceptible to quick fixes. But experience in the Czech Republic, for example, shows that if the incentives are right, the private sector can flourish.

The challenge of improving the business environment in Africa is substantial. It has little institutional capacity. It has low levels of health and education. It is rife with policies and practices inimical to entrepreneurs. And yet it most desperately needs the private sector development that can relieve the burdens on government and provide the growth that can improve opportunities for its people. Substantial commitments to reform and political stability can improve the climate for investment, and it is encouraging to note that several new investment funds focused on Africa have been established. Private investors do see Africa's long-term potential.

Building solid financial systems. Private sector development requires financial systems that are efficient at mobilizing savings and managing risks. It is severely hindered by a weak capital market or a distressed banking system that is not market-driven. Because the financial health of banks determines the quality of their services, governments are now active in reforming their banking systems. This involves strengthening banking regulation and supervision, assuring adequate capital, and improving standards for accounting and payment settlement.

As the reform and restructuring efforts bear fruit, healthy financial intermediaries can sustain credit programs that reach a broad range of borrowers, including small industry, agriculture, housing, municipalities, and infrastructure developers. Because most long-term investment in any country is financed by domestic savings, sound local financial and capital markets are essential to encourage savings. Nonbank financial institutions (such as pension funds and insurance companies) and domestic bond markets are important for long-term finance—especially for infrastructure where revenues are in local currency—and for specialized financial services for entrepreneurs.

Role of the state

Greater reliance on the private sector requires a fundamental change in what governments do and in the way they relate to the private sector. It means that they have to move away from controlled, inward-looking economic systems to competitive, outward-looking ones. And it means that firms have to move from courting the state for special privileges to courting the market for profits. So, governments are moving from being an owner of public enterprises to being a regulator and partner of dynamic private enterprises.

Public sector restructuring has tended to focus on trimming overextended public sectors, supporting the privatization of state-owned enterprises, and moving toward the private delivery of public services. Many countries are establishing the institutional framework for privatization—the policies and procedures needed to facilitate timely, efficient, and transparent divestitures. And a broad spectrum of countries (from Fiji to Argentina) have undertaken major privatization programs. Of particular note are the mass privatizations in Eastern Europe and in the republics of the former Soviet Union. They show that no single method of privatization is right for every country or enterprise and that the privatization is best done as part of a comprehensive structural reform.

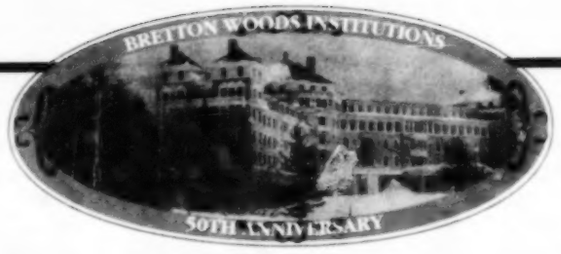
In addition to privatization, there has been a shift toward greater private provision of public services. Many countries are unbundling their infrastructure monopolies, leaving some activities for the private sector and trying to run what they keep on commercial principles. This allows countries to provide services more efficiently and to tap new sources of capital. Telecommunications, power generation, and ports will continue to demand private finance on a grand scale. And more projects will be privately financed in water supply, sewage treatment, toll roads, railroads, gas distribution, and mass transit.

The role of the Bank Group

The main thrust of the Bank Group's efforts will be to create a more supportive operating environment for private business and catalyze funding for private enterprises, especially in support of long-term investments in infrastructure. The Bank Group is differentiating its lending products and policies to match the needs of individual countries. For low-income and transitional economies, broad-based efforts are being made at putting the legal and regulatory framework in place, developing banking systems, and pushing forward with privatizations—to provide the underpinnings of a vibrant private sector. For middle-income countries still involved in reform, the Bank Group is striving to repeat the successes of countries that have developed their private sectors and now attract substantial private capital. And for advanced countries, the focus is on developing capital markets to finance their long-term investments.

- The Bank Group supports $25 billion worth of private investment a year in developing countries, about 10 percent of the private investment by enterprises. The Bank makes financial intermediation loans of about $1.5 billion a year that support $4 billion in private sector investment. The International Finance Corporation (IFC)—through its loans, equity, and credit lines—provides about $2.5 billion a year, supporting about $16 billion worth of projects. MIGA now has about $400 million a year of guarantee operations, supporting about $3 billion in private sector investments.
- The IFC is expanding its investment activities, and is expected to grow at 12 percent a year to reach more than $5 billion by the end of the decade. A quarter of its new approvals are now going to investments in infrastructure. IFC will also help restructure private corporations to enable them to compete effectively in the new global economy, stimulate portfolio investment by promoting such pooled investment vehicles as "country funds," and help emerging markets gain further access to international capital. MIGA is also expanding its guarantee operations.
- The Bank Group will continue to support the privatization of public enterprises, with particular attention to social costs and ensuring that the business environment after privatization is a competitive one. It is also expanding its support for the private provision of infrastructure through its policy advice, its lending, and the selective use of guarantees.
- The Bank Group will step up support for bank restructuring and, as banks become commercially oriented and financially sound, increase lending to them to provide long-term debt financing to private investors. The Bank and IFC will also strengthen the domestic financial sector by supporting the development of domestic bond markets, housing banks, leasing companies, venture capital funds, pension funds, and other institutional investors.
- Given the importance of finance for micro and medium-size industries in creating jobs and taking quick advantage of opportunities—especially in the least developed countries—the Bank is working with a number of NGOs to develop innovative ways of assisting them. This complements IFC's work and its Africa Project Development Facility.

The Bank Group is using a wide range of instruments to help its client countries become more agile in today's new world economy. That agility is essential for an economy's capacity to deal with outside shocks and to adjust continually to a rapidly changing world. It is essential for growth, for new jobs, for broader services, and for the reduction of poverty. ■



Participatory Development: Getting the Key Players Involved

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PARTICIPATORY development—getting all the key people and institutions involved in the development decisions that affect them—is increasingly being recognized and adopted as an indispensable ingredient in making development assistance work.

The growing emphasis on participatory development—*participation*—comes at a time of increasing concern about the relevance and effectiveness of international development efforts to reduce poverty and improve the general well-being of people in developing countries in a sustainable manner. There is a growing body of evidence to suggest that development efforts have a greater chance of being successful in the long run if the key players—governments, donors, and most important, local people—feel they have a genuine stake in the outcome. This involves enabling them to influence and share control over the development initiatives, decisions and resources that affect them.

Over the past few years, the Bank has undertaken a learning process on participatory development approaches, reviewing its own work from a participation perspective and identifying where improvements can be made. At the end of 1990, a Bank-wide "learning group" on participatory development was launched, and was charged with examining the issue of participation and the challenges to the Bank it entailed. This learning process has drawn on the experience and ideas of Bank staff, as well as outside experts from nongovernmental organizations (NGOs), research institutes, governments and other donors. To assist the learning process, more than 30 studies were conducted to examine a wide range of participation-related issues, including its impact on the effectiveness of development projects, and the costs and risks to the Bank of adopting a participatory approach. Much has been learned, but the main lesson is that participation is an essential part of an effective sustainable development strategy.

What is participation?

Participation, as defined by the Bank's learning group, is "a process through which stakeholders influence and share control over development initiatives, decisions and resources which affect them." Who are the stakeholders? Stakeholders are those people—as individuals or institutions—who either affect or are affected by the Bank's policies and actions. In one sense, the Bank itself is a stakeholder, as it is concerned and responsible for the quality of its lending portfolio. In the Bank's work, it is governments, representing borrowing member countries, who are the most significant stakeholders. They, in turn, interact with a range of primary and secondary stakeholders. Given the Bank's overriding objective of poverty reduction, the most important primary stakeholders are the poor, who often lack information and power, and tend to be excluded from the development process. Other primary stakeholders include those expected to benefit from or be adversely affected by projects.

Secondary stakeholders are institutions and individuals with an interest in a policy or project, including NGOs, intermediary organizations, public interest groups, private sector businesses, and technical and professional bodies. Although often not representative of the poor, some secondary stakeholders act in the interest of disadvantaged groups. And, as intermediaries, secondary stakeholders can help foster processes that allow primary stakeholders to become directly involved. Who the stakeholders are varies from project to project. For participatory approaches to be broad-based, they need to seek the involvement of all three stakeholder groups.

Participation in practice

The learning group set out to identify the actual costs and benefits of using participatory approaches in the Bank's work. Comparative studies indicate that the potential benefits of increased stakeholder participation include an increased commitment by stakeholders to policies and projects, a willingness to share costs and an interest in sustaining the benefits, and a check on the relevance, especially to the poor, and on the appropriateness of development efforts.

There is evidence that these factors improve the overall performance of development assistance and help sustain its benefits (see box), and that not adopting participatory development approaches has many costs. These costs include: a lack of support that can impede the use of services, reduce the sustainability of the intended benefits, and limit the cost-recovery of projects; a sense of indifference and dependency on the state by citizens who see they have little or no say in development; and the harboring of resentment and willful obstruction when projects or policies are imposed.

Stakeholder participation does, however, entail a number of costs and risks to both the Bank and stakeholders themselves. These include the upfront financial, time, and opportunity costs to the Bank and stakeholders of engaging with each other; and co-optation of the process by powerful and more articulate elites to the exclusion of the poor and disadvantaged.

In addition, broadening stakeholder involvement may be subject to cultural or political limitations. Women, hereditary castes, and minorities are often overlooked or given token recognition. Assertive disadvantaged groups may be perceived as threats. And genuine stakeholder involvement means that government is often asked to explain the reasons for its decisions to those who engaged in consultative processes. Some governments resist being held accountable in this way.

The Bank's role

In the context of Bank work, the burden of responsibility for participatory processes falls squarely on governments, since it is governments that are responsible for implementing Bank assisted activities. Governments need to be interested in participatory approaches if their efforts are to be sustainable. Participation is achieved by finding ways to draw local people, their associations, and their government into systematic and reciprocal interaction. To make these interactions possible, there must be institutional intermediation capacity. In addition, there must be some capability and willingness to find out who the stakeholders are and to identify culturally suitable participation strategies.

The Bank itself has limited capacity and experience in these aspects of participatory development. In some cases, the Bank's own institutional characteristics and procedures limit the level of participation achieved in Bank-supported activities. These limitations include the typically large scale of Bank lending operations that is not always conducive to community-level participation; the limited field presence of Bank staff for establishing close relations with local organizations; and the frequently felt pressure to achieve planned lending targets that lowers the quality of the participatory process, for instance when physical infrastructure is in place before local organizational capacity has been developed.

Some of these problems have been partly overcome by working in collaboration with other agencies, more experienced in participatory approaches. Implementation of some projects has been successfully delegated to local NGOs and community-based groups. And existing small-scale projects, operated by governmental agencies or NGOs, have been supported by the Bank to expand their coverage.

Still, available studies indicate that broad-based participation is the exception rather than the rule in Bank-supported activities. A review of project documents for lending operations over the last two years in Asia indicates that some 26 percent of projects included some form of participation (including consultation of local populations, implementation by NGOs, and the use of specific participatory techniques). In general, participation has been easier to achieve where the delivery of project benefits brings people together in a way such that they can, or must, develop common interests. When benefits are available to individuals as individuals, rather than as members of communities or organizations, collective participation is less likely. Thus, participation is more common when project benefits relate to communal use of a resource, such as a community forest or a communal water supply, than when benefits are less concrete and individually accrued, such as in some health programs. Yet health programs that address public concerns (such as prevention programs for malaria or AIDS) also benefit from participatory approaches.

Benefits of participation in Bank-financed projects

Participation provides benefits as observed in case studies of Bank-financed projects. These include:

- ***an increased uptake of project services.*** A cotton project in Burkina Faso, which had a participatory focus, showed an almost fourfold increase in the number of farmers affected by the agricultural extension programs, and a doubling of cotton production during the same period. A Bank-financed participatory extension program in Thailand achieved sustainable positive impacts, by working closely with hill tribe communities in defining investment and production priorities, including the use of group problem census techniques.

- ***decreased operational costs.*** When village level water committees were given responsibility for water pump maintenance in a rural water supply project in Côte d'Ivoire, the annual maintenance costs were reduced to less than half those incurred during the previous centralized system, and breakdown rates of hand pumps maintained by water committees were 11 percent, compared with a 50 percent breakdown rate for other water points. In the Philippines, operational and maintenance costs of irrigation systems managed by farmer associations were found to be significantly lower than those for centrally managed systems, due to cost-sharing contributions and policing by the associations.

- ***an increased rate of return.*** In Nicaragua's municipal development project, the quality of completed civil works in barrio upgrading was due in part "to the active participation of the direct beneficiaries in overseeing the operation" according to the Project Completion Reports. This primary stakeholder participation contributed to a rate of return that was 50 percent more than appraised, and the planned 5-year project was completed in three and one half years.

- ***increased incomes of primary stakeholders.*** In the Philippines national irrigation project, the establishment of farmer organizations to manage some of the systems resulted in those farmers gaining better access to agricultural inputs, thus increasing the dry season rice yield, and increasing the net incomes of farmers by an average of 50 percent—the greatest gains achieved by farmers at the tail ends of systems.

The future

The Bank has always interacted with a limited number of stakeholders. However, it has not systematically sought the broad-based participation required by its principal objective of helping its borrowers achieve sustained poverty reduction. The Bank needs to broaden its business practices to encourage the participation of a much wider range of stakeholders, in order to improve and sustain its development efforts. Such a shift would require consistent support from managers and a learning attitude, open to innovation, among those responsible for both lending and nonlending work. There is also a need for clear policy guidelines and practical "how to" advice on the use of participatory approaches. A source book on participation is currently being developed to help operational staff take advantage of these approaches.

The recommendations of the learning group, if accepted and implemented, will be a major step in further defining Bank policy on participation, and strengthening and mainstreaming the Bank's existing work in participation. Only when participation is seen as "the right way to do business" will the Bank be able to effectively encourage and equip borrowing governments to support participation in their own development work. ■

This article is based on the Report of the Learning Group on Participatory Development, "The World Bank and Participation," final draft June 1994.

The IMF as a Monetary Institution: The Challenge Ahead

MANUEL GUITIAN

THE CHALLENGES facing the IMF as a monetary institution have grown ever more complex since its founding. The IMF's mandate must evolve to take into account economic policy interdependence, financial market liberalization, and the new predominance of capital flows. Mr. Guitián presents his insights into how the IMF might respond to these challenges by expanding IMF surveillance, enlarging the institution's oversight to cover capital flows, and substantially increasing its resources.

Half a century has elapsed since the creation of the IMF and the World Bank. In his speech to the Inaugural Meeting of the two institutions, Keynes made many points that are relevant today and will remain so for years to come. Two are particularly important. One is the call for a "perpetual reminder" that the two institutions "belong to the whole world and their sole allegiance is to the general good, without fear or favor to any particular interest." The other is that for the institutions "to win the full confidence of the suspicious world, it must not only be, but appear, that their approach to every problem is absolutely objective and ecumenical, without prejudice or favor."

To a large extent, the ability shown by the two institutions over their first five decades to heed Keynes' reminder is one of the critical forces behind their effectiveness and relevance. The continuation, and possibly the strengthening, of this ability is ever more necessary in view of the challenges the international economy faces as it strides toward the next century.

The IMF's mandate

The impetus for establishing a formal framework for a world economic order came from the desire to avoid the economic, political, and social turbulence of earlier periods. Within that framework, the IMF was charged with safeguarding and monitoring a most important component—the norms guiding the conduct of exchange and monetary transactions among member countries. The original concept postulated a liberal world monetary system based on a clear rule—the Bretton Woods par value regime. But as the international economy evolved, the concept moved toward a system based on national discretion—the generalized flexible exchange rate arrangements currently in effect. Experience with the two regimes has been evenly divided as each has prevailed for roughly 25 years.

The IMF was conceived as and remains *the* institution responsible for the surveillance of the code of international monetary and exchange conduct. This responsibility encompasses: *jurisdiction* over the exchange arrangements of members—the IMF has regulatory functions with regard to these matters; provision of *conditional financial support* to countries in actual or potential balance of payments difficulties—the IMF acts as a lender of financial resources; and *technical assistance*—the IMF provides specific advice on economic policy and statistical matters related to its mandate.

The relationship of the IMF with its member countries has always included some or all of these aspects. But the relative emphasis placed by the institution on each of them has varied over time in response to the needs and concerns of its membership as well as to global economic developments. In the early Bretton Woods period, the jurisdictional and regulatory aspects were emphasized to encourage members to liberalize exchange systems and, more generally, to open their economies to free trade in goods and services. Over time, this regulatory activity was increasingly supplemented by the extension of financial assistance, on a conditional basis, to support economic liberalization. As new members joined the institution, the provision of technical assistance gained prominence.

Evolution after 1970. Exercising jurisdiction became more complex when the Bretton Woods par value system was abandoned in the early-1970s in favor of flexible exchange rates. With this change, the international economy moved from a virtually self-enforcing arrangement to one in which judgment was of the essence. The IMF thus entered a period in which surveillance in an ample sense—encompassing the evaluation of members' macroeconomic policies—became more prominent. This was accompanied by continued institutional support of members' adjustment efforts through conditional access to IMF resources. Apart from the changes inherent in the adoption of flexible exchange rates, surveillance also became more complex because of the progress made in opening

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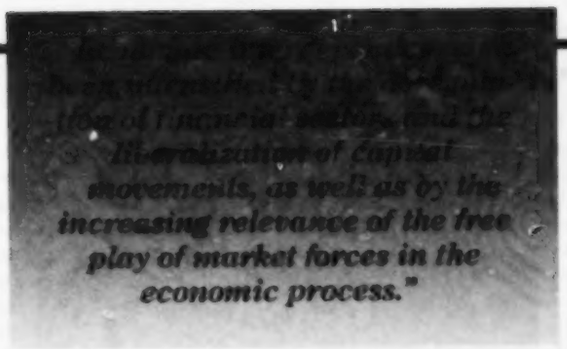

"The globalization of financial markets and the liberalization of capital movements, as well as by the increasing relevance of the free play of market forces in the economic process."

national economies. Openness led to increased economic interdependence, and consultation between the IMF and individual members—bilateral surveillance—had to be supplemented by a review of the policies of all members—multilateral surveillance.

There is no doubt that the IMF has lived up to the challenges it confronted when it was established. Through its monitoring of the international financial code of conduct, the institution has been instrumental in bringing about the substantial opening that has taken place in countries' external accounts. Experience so far has also shown the resilience of the international financial system, as illustrated by its ability to integrate new members in the 1960s and 1990s, to cope with the turbulence of the 1970s, and to resolve the systemic aspects of the debt crisis of the 1980s.

New challenges

The serious challenges facing the IMF and the international economic system today are rooted in the very effectiveness of the institution and the success of the postwar world economic order. Economic interdependence has been intensified by the deregulation of financial sectors and the liberalization of capital movements, as well as by the increasing relevance of the free play of market forces in the economic process. The resulting globalization of capital markets—a logical outcome of these developments—has important implications for the design and implementation of national economic policies and, in particular, for the management of monetary and exchange affairs. It also has a bearing on surveillance and the code of international financial conduct entrusted to the IMF.

The need to integrate economies in transition within the global system has provided a new challenge for the IMF and the world economy. This is a complex endeavor that calls for persistence in the reform efforts by the countries concerned and international support for those efforts, so that the transition to a market-based system can be completed in a manner consistent with a liberal economic order.

Strengthening world economic interdependence also remains a challenge. The larger countries must accept a measure of responsibility for the stability of the system, or what is equivalent, accept the constraint that it imposes on their national economic policies. This responsibility also involves encouraging international resource flows, which provide the best hope for closer and more equitable participation of developing countries in the world system.

As we look into the next century, the challenge ahead for a monetary institution like the IMF is daunting but stimulating. Is the code of conduct for the current and the prospective world economy still appropriate? How should the IMF's responsibilities evolve within a setting of progressively falling economic barriers? These questions can be answered in many ways—the focus here is only on those that pertain to the IMF in its essential role as a monetary institution.

Global financial markets

The predominance of large and at times volatile capital movements poses important questions for the observance of the code of conduct—surveillance and its jurisdictional dimension—and also has important implications for the IMF's financial size and activities.

Relevance of capital flows. The code of conduct permits countries to restrict international capital movements in response to balance of payments pressures. In an environment where, *de jure* or *de facto*, those movements have been generally liberalized, the relevance of this provision may be called into question. There has always been an awkward inconsistency between the code of conduct's advocacy of freedom of current transactions and its acceptance of capital controls. It can be argued that this distinction made sense at the inception of the Bretton Woods regime when the intent was to focus primarily on the liberalization of trade and current payments. But the argument hardly holds today now that current accounts have been broadly opened and capital basically flows freely. Economic logic and reality call for a consistent and uniform approach to all external transactions. In this spirit, the IMF has strengthened its efforts to encourage its membership to shun capital controls and aim toward full currency convertibility. To these ends, the institution is giving increasing attention to capital account developments and their implications for national and international economic policy.

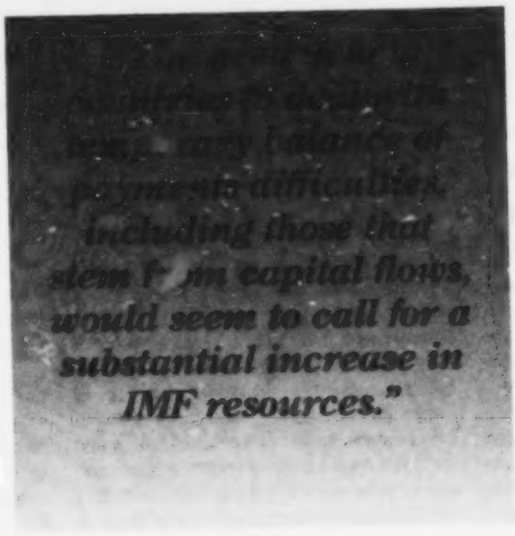
Multilateral surveillance. The importance of capital flows also has other consequences. The original Bretton Woods focus linking exchange rate management to current account flows, thereby stressing the importance of competitiveness, shifted toward the link between exchange rates and monetary policy, and through these linkages, to inflation control. The corollary of these developments has been that the degree of monetary policy autonomy, indeed of the autonomy of domestic economic management generally, has turned out to be more limited than generally thought, even with flexible exchange rates. As a result, the interaction among national economies has become a central aspect of the process of surveillance. In the absence of clear rules, such interaction has increased the complexity of policy evaluation. Not only does surveillance have to adopt a broader-than-bilateral focus, it also must pinpoint the sources of imbalances and assign policy responsibilities for their correction among countries. It is now necessary for all countries to keep their economies on an even keel not just for balance to obtain in each of them, but also to avoid the spillover of disruptions to other countries.

A larger IMF? The growing importance of capital transactions not only calls for the increasing attention of the IMF but it also has potential implications for the institution's financial size and activities. The need to help countries to deal with temporary balance of payments difficulties, including those that stem from capital flows, would seem to call for a substantial increase in IMF resources. The IMF's lending potential should increase precisely because global capital flows are so large. Although such enhanced lending potential would and should be rarely called upon, the IMF must be prepared to act if necessary.

Ideas in this direction have been advanced by the IMF's Managing Director, Michel Camdessus. The Managing Director has advocated the establishment of a fast-disbursing, very short-term lending facility, which would help cushion the reserves of countries suddenly subjected to bursts of speculation in

spite of policies that IMF surveillance had found to be appropriate. Such a facility could help countries that were implementing sound economic policies to avoid being pushed off track and would be useful for developed and developing countries alike.

In a world of global capital markets, an IMF of such characteristics would have to continue to be extremely vigilant to protect its monetary character. The institution's resource base should be sufficient to cope with the balance of payments problems of any of its members, but its financial position should normally be one of ample liquidity. Thus, in sharp contrast to typical financial lenders, in general, the IMF should not be fully loaned up. Ample IMF liquidity would signal the effectiveness of surveillance in averting balance of payments problems. The availability of IMF resources on a scale commensurate with the external payments problems of even its largest members would add to the incentives of the whole membership to seek access to them. This would restore universality to the institution's financial activities, instead of their being confined to a relatively limited set of countries as has been the tendency so far.


"... any balance of payments difficulties, including those that stem from capital flows, would seem to call for a substantial increase in IMF resources."

Global interdependence

The globalization of capital markets has made economic policy interdependence a definite feature of the international setting. If anything, this evolution has added to the relevance of the IMF mandate, and has created an additional mandate for the institution: that of an international forum for the resolution of the issues related to interdependence.

The international economy has seen national financial sectors develop into a sharply competitive world industry. Besides promoting economic integration, this process also led to financial innovation and technological advances, bringing with it new financial techniques and instruments that have altered definitively the nature of world capital markets. A major immediate consequence of these developments is that it has intimately linked exchange rates and exchange market developments—areas of direct importance to the IMF—to national monetary policies and conditions, which are the natural spheres of interest of central banks. A consequence of this relationship is that national monetary policies have become more closely connected.

This evolution has a variety of implications for the IMF, particularly for its surveillance role. One is to underscore the institutional aim of promoting monetary and economic policy consistency. With national economic openness, the ability of monetary policies to attain domestic objectives has been substantially reduced. An important task for the IMF will be to help ensure that national monetary policies remain compatible with global financial stability. Another implication is that the IMF must examine, in close consultation with member governments, the consequences of financial market innovation for national monetary and exchange policies and for the international financial system. Yet another issue is the role that should be played by the IMF when pressures develop in international monetary and exchange relationships.

Balancing objectives. On the first issue, financial stability, there is consensus that the primary objective of national monetary policies should be monetary stability, generally interpreted as stability in the domestic price level. Together with this consensus has come the agreement that the pursuit of this objective must be insulated from day-to-day policy requirements and, more broadly, from political compromise. This view is well-illustrated by the importance given to ensuring central bank independence in a growing number of countries. These trends can and should be supplemented at the international level in a variety of ways.

Concentration on the attainment of domestic price stability must not be at the expense of preserving a viable balance of payments position—a primary responsibility for the IMF. One area where surveillance can complement national policy implementation is in making sure that domestic economic objectives conform to international constraints. But monetary stability is not always assured by a stable domestic price level, important though such an aim is. It also requires exchange rate stability, yet another subject of fundamental importance for the IMF and its members.

The essential task is to ensure that the objectives of internal monetary (domestic price level) stability and of external monetary (exchange rate) stability do not compete with one another. While conflicts are inevitable in a world with unanticipated economic disturbances, they cannot be sustained and, therefore, it would be futile to pursue one of these aims at the expense of the other. The often heard argument that the objective of a stable price level should be sought over the medium run and not be made subject to short-run policy compromises applies to the aim of exchange rate stability just as well. This observation carries obvious implications for the concept of the independence of central banks, concerned as they are with inflation control and monetary stability.

Lender of last resort. The second issue—the implications of the rapid evolution of international financial transactions—brings to the forefront an important aspect of monetary and central banking policy on which there is less consensus, though there is agreement on its importance for monetary and economic management. A traditional central bank function has been the discharge of lender-of-last-resort responsibilities, which brings with it concern over the soundness of the banking sector. The developments in international capital markets—their globalization, growth and increased complexity—put these subjects in a new light and on an unprecedented scale.

There are many aspects to consider: the impact of capital market globalization on the activities of banks; and the emergence of new actors in the international capital flow scene, such as institutional investors. These developments raise the question of the appropriateness of prevailing national prudential supervision norms, that is, do they help ensure a level playing field across all economic agents? Finally, there is the role of the emergence of new instruments and financial techniques in blurring the traditional separation between bank and nonbank financial intermediaries.

All these developments add to the complexity of monetary policy, which must be extended beyond the conventional macroeconomic objective of monetary stability. They underscore that the attainment of this aim goes beyond the search for domestic price or exchange rate stability. The effectiveness of monetary policy requires the existence of a

competitive and sound financial sector, thereby bringing supervision and prudential regulation squarely into the domain of central banking. Indeed, it can be argued that, despite the importance of these issues for effective monetary management, focus on domestic price stability has relegated them to a neglected dimension of monetary policy.

Discipline and governance. It is in the interplay between market forces and monetary policy that the role of the IMF lies. This role is based on the issues of market discipline and governance. Although governments have increasingly favored market forces, they have been generally reluctant to accept the full force of market-imposed discipline. This reluctance is even more apparent in banking and finance, where important spillover effects can arise. Because of these spillover effects, financial deregulation must be accompanied by an appropriate framework of supervisory norms to guide market forces.

It will be important to harmonize this framework across countries. The IMF has a role to play in this process both systemically and on a country-specific basis: systemically, because of its institutional interest in and responsibility for the prevention of macroprudential policy problems (such as those that were posed during the 1980s by the debt crisis); and from a country-specific perspective, because of the IMF's mandate with regard to advice and consultation on domestic economic policymaking.

The IMF at the center. The third issue—the role to be played by the IMF in the presence of systemic pressures and tensions—leads directly into a discussion of the desirable evolution of the institution. The main lines of such an evolution flow from the arguments made so far and they include: the eventual extension of IMF jurisdiction to capital transactions, scaling the institution's resources accordingly, and emphasis on surveillance as well as growing participation in the efforts to protect the soundness of the international financial system.

Given its global scope, the IMF should be able and ready to come to the assistance of any one of its member countries under certain conditions and in certain circumstances, just as a national central bank stands ready to help its banking system. This role would require member governments to place a significant portion of their international reserves in the IMF, just as banks do in their national central bank. But for this scheme to function properly, member country claims on the institution—their quotas—must be kept unequivocally liquid, which means that use of IMF resources by member countries must remain temporary and of short duration. The attention of the IMF must be focused on its contribution, through surveillance, to exchange rate stability, balance of payments viability and more generally, macroeconomic balance in members' economies and financial stability in the system at large. Its lending activities are only an instrument to support those aims, that is, a means of exercising policy surveillance at a second remove.

The missing feature—and a remaining challenge—for the IMF as a supranational monetary authority, relates to the issuance of its own liability. Quite early in its evolution the IMF took steps in that direction with the creation of Special Drawing Rights (SDRs). But the SDR has yet to acquire the full set of characteristics of an international money, which include its becoming the numeraire as well as providing the central anchor of the international monetary system. If this challenge were met—and this may represent a distant goal—it would be possible to equate the aim of stability of the value of money with the achievement of price level stability on a global scale. In such circumstances, it would be true that global price stability would ensure the maintenance of the value of international money. But this will require a substantial strengthening of the consensus on the supranational role of the IMF and on the future of the SDR along the lines just described.

The road ahead

In the years to come, the IMF will have to function in an environment that differs fundamentally from that which prevailed at its inception. The world economy is no longer characterized by components separated by national economic boundaries, by optimism concerning the efficiency of governments to guide economies and by a belief in the effectiveness of demand management policies to influence economic performance. Instead, the setting at present and—barring major crises—in prospect for the coming century is one of closely integrated national economies, indeed a single global economy for all practical purposes; awareness of the limitations of economic policies to attain real economic objectives (but also of their strength to thwart the achievement of these objectives); a general consensus on the importance of market forces as the key instrument for efficient resource allocation; and more realism regarding the role of government as the driver of the economic process.

The presence of a global economic setting and the predominance of market forces have constrained the effectiveness of national economic policies as well as the margin available for policy inconsistencies across countries. A world market and freedom of market forces will in the end eliminate inconsistent policies, and will do so rapidly and not always in an orderly fashion. Well-designed, consistent national policies foster orderly conditions in the world market, whereas, policy inconsistencies promote market disorder.

The IMF can and should provide the means to bring about an orderly resolution of national policy inconsistencies—but in a way that conforms to fundamental market forces. To this end, it would be helpful to reestablish clear rules to guide the interactions of national economies, or failing that, to reach reasonable understandings to allocate primary policy adjustment responsibilities among countries. The IMF should be helped by the membership in its attempts to strengthen the process and the means of economic policy coordination. In the absence of such a joint effort, the prospect is essentially for policy coordination by force, that is, coordination brought about by market reactions, which on occasion may prove disruptive.

An outstanding contribution that the Bretton Woods conference made to international economic relations, particularly in the monetary and exchange areas, was the establishment of a set of principles—embodied in the IMF's Articles of Agreement—that provided a basis for economic governance at the international level. Such international governance was a real breakthrough because it provided the basis for the distribution and adjudication of rights and obligations among countries as well as the forum for the resolution of conflicts of interest.

International economic governance must be founded inevitably on openness. It is not surprising, therefore, that an international regime based on and aimed at a liberal world economic order, despite its move from rules to discretion, has been effective in integrating national economies into a global market. The governance requirements of the system that has now been established are far more complex than those that had to be met at the outset. At that time, the challenge was to free basic economic forces. Now, this process has been virtually completed. The challenge now is to channel market forces and, when misguided, reorient them in the direction of sound world economic performance. The importance of monetary stability for the efficiency of market forces is well established at the national level. A similar proposition applies at the international level. A multilateral institution like the IMF described in this article, with a universal mandate for global monetary stability, can make a unique contribution toward its attainment. ■

Adjusting to Development: The IMF and the Poor

BORIS BERNSTEIN AND JAMES BOUGHTON

THE IMF's approach to dealing with poverty has evolved—and is continuing to evolve—over time. Both internal and external debate have stimulated changes in the institution's policy framework, as have shifts in the structure of the IMF's lending. Ultimately, regard for the human costs involved during adjustment or transition to a market economy is essential if adjustment efforts are to be successful.

The IMF's Articles of Agreement—its founding charter—give the institution a mandate to foster economic development as well as to promote stability and external adjustment. While these are essentially macroeconomic concerns, they cannot be effectively pursued in an economy with serious structural imbalances. Nonetheless, until the late 1970s, the IMF had dealt with both issues primarily with macroeconomic instruments. This emphasis resulted in part from the nature of the IMF as a financial institution; from the existence of its sister institution, the World Bank, whose role in dealing with structural problems was more clearly defined; and from the fact that the demand for IMF resources had come primarily from the more developed economies.

As the number and size of arrangements with developing countries increased in the late 1970s and early 1980s, the IMF became increasingly concerned with structural issues in general and with the social aspects of adjustment in particular. While other agencies aim more directly to alleviate poverty in the long run, the role of the IMF in this context is to provide support for adjustment programs that make economic growth sustainable and to mitigate the adverse effects that essential adjustment measures may have on the poor in the short run.

As the institution has tried to incorporate these concerns into adjustment programs, it has confronted a number of challenges, including identifying those who would be least able to absorb the transitional costs of adjustment; assessing the effects of conventional macroeconomic adjustment programs on the disadvantaged; and finding alternative strategies that could ameliorate the short-term effects on the poor without sacrificing the longer-run macroeconomic benefits. In an effort to meet these challenges, the IMF has developed a cooperative approach with the countries concerned.

The adjustment challenge

Developing countries drawing on IMF resources have faced daunting conditions: large fiscal and external deficits, significant debt burdens, high unemployment often combined with chronic inflation, low growth aggravated by structural problems, and weak demand for exports exacerbated by protectionism. The IMF has provided credit and policy advice to many members in such conditions, often in an environment of crisis, and has made those credits conditional on reforms in macroeconomic policies (IMF "conditionality"). To provide enough time for those policies to work and for lasting structural reforms to be implemented, special facilities (IMF lending arrangements) with a longer time horizon—three years or more—such as the extended Fund facility (EFF), the structural adjustment facility (SAF), and the enhanced structural adjustment facility (ESAF), have been established over the years. More recently, a temporary facility—the systemic transformation facility (STF)—was created specifically to address the special circumstances facing economies in transition from central planning to a market-based system. Adjustment, however, remains no less difficult, and many countries have found it necessary to cut expenditures on education, health, and social services in order to meet the required fiscal targets.

The IMF's traditional approach to conditionality has focused on the importance of orderly and timely adjustment. This approach has been based implicitly on the assumptions that a comprehensive adjustment program would protect the interests of the most vulnerable in the short run by preventing the inevitable chaotic adjustment process that arises from suppressed macroeconomic imbal-

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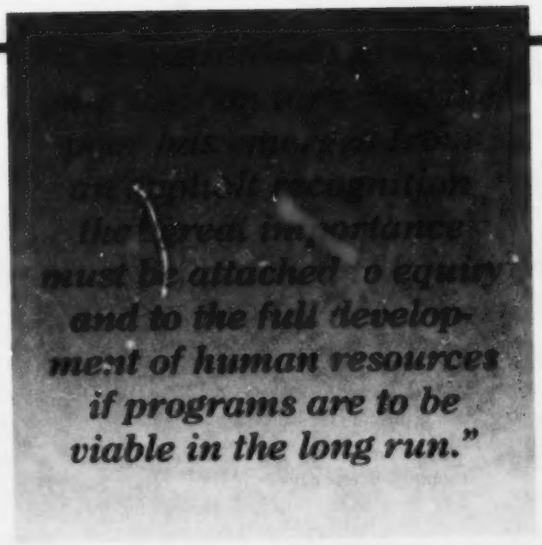
ances, and in the long run would aid the poor by fostering sustainable growth. The distribution of income in this approach was generally left to the country concerned, although in countries where the authorities have recognized and have been sensitive to the needs of the poor, there has always been room for programs to include income-supporting measures, such as increases in producer prices and improvements in access to credit by the agricultural sector.



The need to re-examine this approach was recognized by the management and staff of the IMF by the early 1980s. Yet building in well-tailored measures to protect the most vulnerable is not a straightforward task. The political difficulty of undertaking adjustment is aggravated by the conflicting needs of various domestic groups that could be adversely affected by the program. If an adjustment program is designed without regard to its effects on the poor, its insensitivity may become the subject of protests, and it will be unlikely to command the broad support (either within the country or among potential creditors and donors) that is essential for sustained success. On the other hand, targeting the poor for protection may impose substantial short-term costs on other groups that are better off economically but that have greater political power. Ignoring the needs of the influential urban middle class, for example, could undermine the adjustment program just as much as ignoring the needs of the poor.

This point has been a recurring theme in internal discussions at the IMF over the years, and it is a political reality that must be faced in negotiations with governments. Nevertheless, the management of the IMF has come down squarely and clearly on one side of this debate. The institution's growing emphasis on targeting the poor has emerged from an explicit recognition that great importance must be attached to equity and to the full development of human resources if programs are to be viable in the long run.

Internal debate

Over the years, the IMF's experience with financial programming has made it increasingly clear that the emphasis on short-term macroeconomic solutions to adjustment challenges is inadequate in cases where a country's long-term interests are subsumed under shorter-term social hardship and political realities. The institution's management has initiated and encouraged a number of internal studies since the late 1970s to focus attention more specifically on identifying and protecting the interests of the poor. These studies have comprised both postmortem evaluations of programs for individual low-income countries—which have amply demonstrated the difficulties posed for program viability when the poor are unduly affected—and general studies of the links between program design and income distribution.

A number of important conclusions for the design and evaluation of programs came out of the studies. A conclusion of one early study, by Omotunde Johnson and Joanne Salop, which analyzed the effects of IMF policies using a simple tradables/nontradables model, was that stabilization programs necessarily have distributional repercussions but that the specific effects can be positive or negative, depending on the structure of the economy. For example, in an economy where the export sector is large and marked by small-scale agricultural operators, as in Ghana, a devaluation could have egalitarian effects. In other cases, the implications may not be as favorable. In Bolivia, to take another example, much of the primary export—mineral products—was produced in public enterprises, while lower-income segments of the population largely produced nontraded agricultural products and simple manufactures. The shift in internal terms of trade required by adjustment would therefore tend to disadvantage poorer groups in Bolivia.

Another study, undertaken by Jitendra Borpujari in the early 1980s, developed a framework for incorporating financial constraints into a model in which development depends essentially on an economy's ability to provide for the population's basic production and consumption needs. Using this framework, the study found that purely macroeconomic financial programming is appropriate only for economies for which development is not constrained by a shortage of production of basic goods. In economies that are so constrained, a given inflow of foreign exchange will strengthen development potential only if it is used to import investment goods or basic consumption goods.

In the mid-1980s, the IMF's Fiscal Affairs Department undertook a more comprehensive study of the distributional effects of adjustment programs. The study created a stylized, typical IMF-supported adjustment program from the experience of 78 countries and compared this program with a synthetic, counterfactual experience depicting what would have happened in the absence of a stabilization program, focusing on short-term effects. The study concluded that there is no evidence that adjustment programs supported by the IMF are more damaging to income distribution than the practical alternatives. However, some policies could have relatively beneficial distributional effects in the context of a comprehensive program. These include eliminating restrictive exchange practices, expanding access to credit markets, broadening the tax base, restructuring indirect taxes, limiting expenditures on defense and "grandiose public works," and, in some circumstances, correcting an overvalued exchange rate.

Other catalysts for change

Several developments in the global economy that converged in the 1970s, as well as criticism from outside the IMF, also contributed to the IMF's growing concern with designing adjustment programs that incorporated safety nets to protect the most vulnerable.

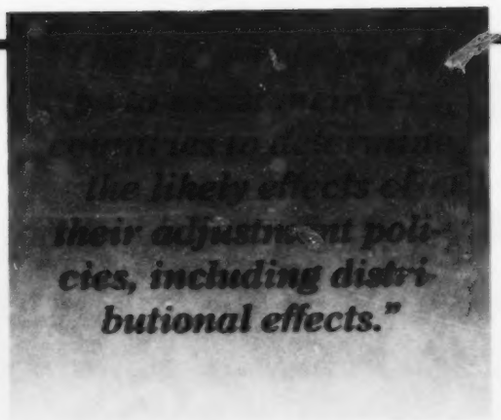
Shift in structure of IMF lending. First, private capital markets began to play a larger role in financing international payments, especially for the more developed economies. Second, conflicting approaches to macroeconomic policy among the large industrial countries first weakened and then pulled down the par value currency system that had

prevailed since the end of World War II. As a result, by the end of the 1970s, the IMF's role in financing imbalances among the industrial countries had virtually disappeared. Third, a combination of adversities—the slowdown of growth in industrial countries, the worsening terms of trade, and the failure of many countries to adjust promptly to disturbances—heightened the financing needs of less developed economies.

The poorer countries that lacked access to private capital markets increasingly turned to the IMF and other multilateral agencies for help in the 1970s and even more so in the 1980s. Furthermore, many developing countries that had borrowed heavily from commercial lenders in the 1970s came to the IMF when that source of financing first became much more expensive and then suddenly dried up in the wake of the debt crisis.

External criticism. Literature on the social costs of adjustment, which burgeoned in the early 1980s, reflected its growing importance as more countries faced the need to implement painful policy changes and as attempts to implement traditional adjustment programs occasionally led to violent protests. Critics contended that although the specific effects of an adjustment program could not be predicted or even identified afterward, the IMF should realize that its recommendations might considerably increase inequalities. According to these critics, the institution would be more effective if staff considered the sociopolitical context of economic disequilibria and explored the distributional effects of its programs.

Among the criticisms of conventional adjustment paradigms was that the emphasis given to increased taxation and higher interest rates in many programs could lead to a squeeze on the private sector and restrict long-term investment and growth. At the same time, reducing or eliminating subsidies for food, education, and health would decrease real income—worsening the plight of the poorest and damaging the country's growth potential. The IMF's long-held view that orderly adjustment necessarily benefited the poor in the long run, a view often characterized as a "trickle-down" approach, was faulted for being no longer adequate. In general, the IMF was encouraged to make its adjustment programs more "people sensitive." Finally, some criticized the IMF for "meddling" in countries' internal affairs, although others felt that there were compelling reasons for the institution to encourage structural reforms related to the alleviation of poverty.



The new policy framework

Spurred by these developments of the 1970s and early 1980s, the IMF's Executive Board took up the issue, in July 1985, of how adjustment programs affected income distribution. Two basic messages emerged: first, it was difficult to draw firm conclusions about the effects of conventional programs without specifying viable alternatives. As staff studies had already made apparent, there was insufficient evidence to predict whether a typical program would have positive or negative effects on income distribution. To firm up the conclusions would require asking whether some other adjustment program would have been as effective in promoting sustainable growth but with more favorable distributional effects. The second message was that, whatever conclusions might emerge from this and further research, policies toward the distribution of income were essentially a domestic matter and should not be subjected to IMF conditionality. The IMF's role should be to assist member countries to determine the likely effects of their adjustment policies, including distributional effects. To further that objective, more detailed staff research was undertaken, which led to greater emphasis being placed on social safety nets.

The IMF coordinates with other agencies. Another effort that would further the objective of helping member countries evaluate the effects of their adjustment policies would be through strengthening cooperation in this field with other development institutions. The IMF's liaison with the United Nations has been strengthened in a number of ways. The Managing Director participates regularly in meetings of the United Nation's Administrative Council Committee, a forum in which he frequently exchanges views with the heads of agencies that work more centrally with poverty-related issues. On an informal level, IMF staff have been meeting occasionally since the mid-1980s with their counterparts in agencies such as United Nations Children's Fund (UNICEF) and the International Labor Organization (ILO) to discuss problems of common interest. These contacts led, for example, to an initiative under which UNICEF would encourage governments of selected countries to redesign adjustment programs so as to include more measures targeted at the poor, and the IMF would assist governments in that effort.

Collaboration between the IMF and the World Bank was greatly intensified following the launch of the SAF in 1986 and the ESAF in 1987. Because the programs and institutional expertise of the Bank and the IMF complement each other, the two organizations have worked closely together to design programs under these two facilities, which provide financial support on concessional terms for countries with very low per capita incomes but which differ in the source of their funds and in the terms of their support. IMF staff have also participated in World Bank missions on poverty in other program countries.

The primary vehicle for collaboration under these facilities is the policy framework paper (PFP), designed as a framework for medium-term programs of policy reform agreed upon by the country, the Bank, and the IMF. Most PFPs include a section on the social implications of the adjustment program, and some a discussion of mitigating measures and requirements for social safety nets. Such measures can be divided into four categories: targeted subsidies of essential goods; cash transfers to vulnerable groups; direct support for wages, producer prices, and targeted public works; and protection of education and health expenditures. According to a recent internal review of IMF experience, while only 1 of 5 ESAF-supported programs in place by 1989 contained specific social measures, 5 out of the subsequent 12 ESAF-supported programs in place by April 1991 contained such measures, and most subsequent programs did as well.

Perhaps the most well-publicized case of the use of the structural adjustment facilities to promote programs that protect the interests of

the disadvantaged is that of Ghana. The Ghanaian adjustment programs—supported by the IMF for four years starting in 1987—were initially implemented under the EFF and the SAF (1987–88) and later under the ESAF (1988–91). Notwithstanding the difficulties experienced in implementing the program, the government sought throughout this period to improve its social policy, especially beginning in 1988 with the implementation of a "Program to Mitigate the Social Costs of Adjustment." The primary objective of the program has been to enhance the delivery of basic services to the poor, raise the productivity of lower-income workers, and enhance their employment opportunities. The program is financed externally, in large measure through support pledged from bilateral donors at an international conference convened by Ghana in Geneva in February 1988. The IMF's assistance was designed not only to ensure the viability of macroeconomic policies but also to support a fund established to retrain, relocate, and redeploy public employees displaced by the restructuring of the economy.

Technical assistance and policy advice. The IMF now offers technical assistance to member governments desiring advice on social safety nets and on other distributional issues. Throughout the former Soviet Union and other countries in transition from central planning, the IMF has provided assistance to improve the efficiency and financial stability of social security and other social assistance programs. This work is exemplified by the 1990–91 stand-by arrangement with Poland. Because of severe dislocations associated with the transition to a market economy, the authorities—with strong support from the IMF—decided to underpin the macroeconomic reforms by creating a social safety net to shield the most vulnerable from the effects of adjustment. They financed these social programs by reallocating resources previously devoted to subsidies on food, agricultural inputs, and coal. Three groups were targeted: pensioners, the unemployed, and the poorest. A labor fund to assist the unemployed, for example, was financed through a levy on enterprise payrolls and through budgetary transfers. The authorities also sought external concessional assistance to help them strengthen their ability to implement these measures.

Can more be done?

The evolution of IMF policy on poverty has reflected the changing needs of its membership as well as a growing awareness and concern within the institution. Over time, the IMF has developed an approach to poverty that seeks to balance its mandate to achieve balance of payments viability and growth—and avoid interfering in members' social and political affairs—with a greater flexibility to address short-term social concerns. In the long run, poverty reduction is achieved primarily through economic growth and human resource development, supported by a favorable external environment.

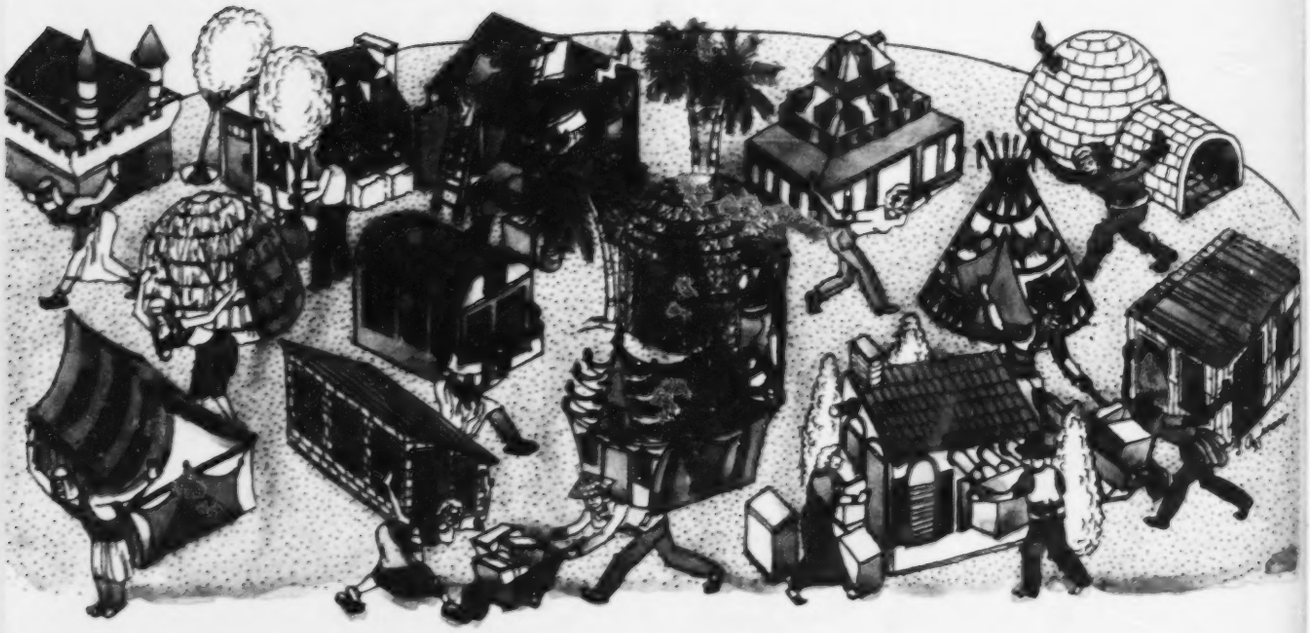
Although the IMF has avoided conditionality related to income distribution, concern with social costs has increasingly become a priority. This evolving approach has three prongs. First, the institution has begun to endorse a more gradual application of measures that might have a negative impact on the most vulnerable groups. The applicability of this approach is limited, however, because in many cases the rapid correction of gross distortions in relative prices is crucial for the program and because rapid adjustment may be essential in severe cases. Second, the IMF supports countries' efforts to seek additional aid from other international institutions or donors. Third, government expenditures are being targeted more specifically to meet the needs of the poor and to provide effective social safety nets. The dominant constraint on the IMF's work in this area is its dependency on cooperation from the countries concerned. Because the poor are not the only group—and almost certainly not the most politically powerful group—that could be adversely affected by the need for adjustment, governmental support for measures aimed at the poor may not be easy to secure. This last prong goes to the heart of what has so often been missing from programs designed to help countries in difficulties: a sufficient regard for the human costs involved during adjustment or transition to a market economy. That this prong needs further sharpening is beyond doubt. What is needed is not only further research into the design of cost-effective social safety nets, but also a broader commitment from governments as well as from the IMF. ■

In a statement before the United Nations Economic and Social Council in Geneva, on July 11, 1990, the Managing Director of the IMF, Michel Camdessus, spells out the IMF's aim in helping its developing member countries. Protecting the poor and enhancing their productivity are high priorities.

"The fact remains that the transition from an economy ridden with imbalances and rigidities to a high-quality growth path is always difficult and can sometimes take longer than we tend to believe. Some policies that are necessary for this transition may hurt some of society's vulnerable groups in the short run. With the governments concerned, we are making a serious effort to contain and mitigate such ill effects and to introduce appropriate "safety nets." We are striving to improve the design of our programs to ensure a better blend of adjustment, growth, and equity and, in particular to ensure that the plight of the poor is properly recognized."

Population Resettlement and Development

MICHAEL M. CERNEA



FOR DEVELOPMENT purposes, involuntary population displacement is sometimes inevitable. Re-establishing resettlers on a sustainable, productive basis is costly. Yet doing resettlement badly is even costlier—and socially disastrous.

Infrastructure is the physical scaffolding that shoulders economic growth and widens people's access to electricity, clean water, transportation, communication, and other services. In developing countries, infrastructure attracts annual investments in the $200 billion range. Tangible social welfare improvements, in addition to economic benefits, are the result: the share of households with access to clean drinking water has risen by 50 percent in the past 15 years; per capita access to electric power and telephones has doubled; and over half of the increase in food production has come from investments in irrigation. Yet the building of infrastructure also has some negative social effects. Among these, the most difficult and complex is the involuntary displacement and relocation of local populations.

Involuntary resettlement has been a companion of development throughout history, indelibly written into the evolution of industrial as well as developing countries. Installing major hydropower dams, irrigation and drinking water systems, or extending highway networks have entailed displacements too often fraught with hardships and deprivation. The beautiful master-plan of today's Paris was made possible by painful relocation in the XIXth century under the firm hand of Baron Haussmann. New York's impressive Cross

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Bronx Expressway slashed through many neighborhoods, of which some could have been saved. The huge hydroelectric complexes in Canada required the uprooting of many indigenous groups, often with scant regard to traditional rights and cultures.

But in recent decades, the scale of development-related population displacement has grown rapidly in developing countries—especially in Asia—reflecting the accelerated provision of infrastructure and growing population densities. A recent World Bank study estimates that this type of displacement affects at least 10 million people in the developing world annually: 4 million people displaced by the some 300 large dams (above 15 meters high) typically begun each year, and 6 million people displaced by urban development and transportation programs. Over the past decade, an estimated 80–90 million people have been forcibly resettled by such investments.

Given these numbers, involuntary displacement is fast becoming a matter of worldwide concern. The main problem is that this type of displacement usually goes hand in hand with loss of livelihoods and impoverishment—the opposite of developing countries' poverty reduction and development goals. This is especially serious since many of those adversely affected are already very poor, and live in disadvantaged areas where infrastructure is lacking and social services are limited. The remote locations of many dam sites are often inhabited by indigenous people, ethnic minorities, or pastoralists.

When people are forcibly displaced, production systems are dismantled. Many jobs, much valuable land, and other income generating assets are lost. Health care tends to deteriorate. Kinship groups and informal social networks for mutual help are scattered. Links between producers and their customers often are severed and local labor markets are disrupted. Ancestral shrines and graves must sometimes be abandoned, breaking links with the past and with people's cultural identity. And not only the affected people are worse off: when displacement is massive, it weakens also the local and regional economy.

Not surprisingly, therefore, doubts are being raised about the economic wisdom and social justification of investing in infrastructural projects, unless advance measures are taken to re-establish the affected people on a productive basis. In an effort to better understand the resettlement implications of development programs worldwide and the solutions to the social problems they raise, the Bank undertook a study of all 1986–1993 Bank-financed projects entailing resettlement, as well as of many resettlement operations outside Bank-financed projects. The study—perhaps the most important social impact assessment ever carried out by the Bank—found that although progress has been made in recent years, major difficulties and failures remain, with implementation performance often lower than expected.

The Bank's role

Within the worldwide picture of development-caused resettlement, projects financed by the Bank account for a relatively small, but significant, share of the total. In 1993, projects in the Bank's active portfolio accounted for some 3 percent of the resettlement caused by dam construction worldwide and about 1–2 percent of the displacements caused by urban and transportation projects in the developing world. In total, these Bank-financed projects are expected to entail the resettlement of 2 million people over an eight-year period. Although these projects are spread over 39 countries, the vast majority—60 percent of all projects and 82 percent of displaced people—are concentrated in South and East Asia.

Individual resettlement project components vary enormously in size and complexity. Some may affect only 200–300 people, while the largest operations move tens of thousands. In India, the Bank-assisted Upper Krishna II Irrigation dam project has to resettle some 220,000 people and the Maharashtra Composite Irrigation III project 168,000 people. In China, the Shuikou project has displaced and resettled already close to 70,000 people, and the recently approved Xiaolangdi Dam project—181,000 people. In Indonesia, the Jabotabek Urban project displaces nearly 30,000 people.

The significance of the Bank's role, however, far exceeds the size of involuntary resettlement under Bank-financed projects. The key reason is the Bank's explicit and path-breaking resettlement policy, adopted as early as 1980: it defined a clear goal—income restoration—and innovative procedures and approaches, including a redevelopment plan and timetable, for achieving good resettlement. The difference from common practices is clear: displacement approaches based on eminent domain law and expropriation are only *limited to compensation for things lost*; by contrast, the Bank's policy promotes approaches *centered on people and restoring their productive capacity and livelihoods*. The gradual diffusion of the Bank's development-oriented resettlement policy focused on people may improve the bulk of involuntary resettlement that occurs outside Bank-financed programs.

Resettlement implementation is the borrower's responsibility, but the Bank sees as its own role helping the borrower ensure that every effort is made to restore, and if possible enhance, resettlers' livelihoods. Improving resettlement is necessary yet difficult for developing country governments, particularly in low-income countries with land scarcity.

What the study found

The key message of the Bank's study is that *good resettlement can prevent impoverishment* and even reduce poverty by rebuilding sustainable livelihoods. Socially responsible resettlement is also economically beneficial because the heavy costs of poorly handled displacement extend well beyond the immediately affected population. Conversely, inadequate resettlement induces local resistance, increases political tensions, entails extensive project delays, and postpones project benefits; the benefits lost sometimes far exceed the marginal cost of a good resettlement package. Moreover, if resettlement is not planned and financed adequately, resettlers end up worse off than before. Thus, ensuring that involuntary resettlement is minimized—and when unavoidable, is carried out without impoverishing the people displaced—is justified on both economic and ethical grounds.

Experience has shown that resettlement is nearly always more difficult, more expensive, and more time-consuming than generally realized. Yet despite the vast differences among countries and populations involved, much more is now understood about the major common factors—political commitment, sound social analysis, good costing and financing, and public participation—that explain, by their presence or absence, why resettlement worked in some cases and failed elsewhere.

Political commitment. The adoption of legal frameworks and national or sectoral resettlement guidelines is a clear expression of political commitment to contain unnecessary impoverishment from displacement. Since some 97 percent of the worldwide displacement occurs in projects not subject to the Bank's policy, or to any explicit development policy, *the enactment of development-oriented domestic guidelines is critical*. With the Bank's assistance, several borrowers—such as in Brazil, China, and Colombia—have enacted or improved domestic policies for resettlement. Recently, the development ministers of all 23 OECD countries sanctioned unified resettlement guidelines, similar to the Bank's policy, for all aid agencies of OECD donors.

The Bank's concern that borrowing countries adopt their own legal framework and policy guidelines results from learning the hard way that the absence of policy is a policy by default. Some agencies prefer to maintain a policy vacuum rather than issue binding

From violent expulsion to reduced displacement

Two ongoing forestry projects—both of which seek to eliminate encroachment in gazetted African forests—demonstrate dramatically the difference that policy strictures make.

A few years ago, a forest management project started by the Ugandan Government, with financial assistance from a multilateral European donor agency, undertook the massive displacement of communities living in the Kibale game corridor and forest reserve, without offering them any viable economic alternative. The field assessment of a social anthropologist reported that: "... *on March 31, 1992 and for some days following, an attack without prior warning was launched by game wardens, foresters, local government officials, and perhaps prison labor. All houses were burned, and personal property and food stores were either destroyed or looted. A handful of people were killed on the spot. Patrols have kept people from returning since.*"

By the end of 1992, about 35,000 people had been violently evicted. Little is known by project authorities about how they have fared. Assistance to these people was not given until a few months later when some of them were placed in new settlements 150 miles away, in the underpopulated county of Buganguizi. They were provided with only a few tools from relief agencies and essentially were left to fend for themselves. Sadly, this is not an isolated case.

By contrast, a World Bank-assisted forestry sector project in Côte d'Ivoire made resettlement an upfront issue. The project was intended to prepare and introduce forest management plans for several high priority areas. Learning at appraisal that the Forestry Department planned to evict up to 200,000 residents in a manner similar to that in Kibale, the Bank insisted on a different approach, one that would: reduce displacement from about 200,000 people to less than 40,000; provide better conditions for resettlers; consolidate existing scattered populations into "agroforestry zones" within the legal limits of classified forests; and integrate resettlers into forest management general plans. What could have been a massive and violent uprooting for tens of thousands of people was averted. Even so, many problems remain, which is why the Bank keeps this project on its problem list, monitoring it closely.

norms and legal strictures for activities that they know are going to be problematic or controversial. Avoiding formal policy commitments may leave more operational flexibility in the short term, but at the expense of higher long-term costs. The absence of a resettlement policy sometimes results in the use of violent displacement procedures, without due recognition and protection of the basic rights and entitlements of those uprooted. The Bank has steadily and effectively opposed such practices as unacceptable, and prevented them from occurring in Bank-assisted projects (see box).

Clear evidence of the value of government commitment is provided by [illegible] China. Before the late 1970s, China lacked a legal framework for resettlement: the results were tragic displacements, such as those from the Sanmenxia (319,000 people) and Danjiangkou (383,000 people) reservoirs in the 1960s and 1970s. To correct this, a series of laws and regulations were adopted between 1978 and 1992, either with national applicability or tailored to specific investment sectors such as water, transport, industry, and urban. These regulations apply to all types of resettlement projects and, taken together, protect the living standards of those affected, affirming the principle of "resettlement with development." This principle requires making resettlement a development opportunity and improving resettlers' livelihood after relocation.

Focusing on income restoration. The most severe risks intrinsic in displacement occur along several lines—landlessness, joblessness, homelessness, marginalization, food insecurity, decrease in health levels, loss of access to common property assets, and social disarticulation.

Overall, the study found that ongoing Bank-assisted projects create better conditions for resettlers than similar projects in the past. Projects that resettle people productively on land and in jobs restore income more effectively, after a transition period, than projects that hand out cash compensation, without institutional assistance. Successful income restoration is achieved primarily when projects enable resettlers to share in the immediate benefits created by the very project that displaces them. Effective strategies include moving resettlers into newly irrigated command areas; helping them start reservoir aquaculture (Saguling reservoir, Indonesia); favoring resettlers to exploit commercial opportunities around newly constructed infrastructure (Shuikou dam project, China); and assisting them in building improved housing.

However, inadequate resettlement design or implementation in a number of completed projects has left many resettlers worse off. Contraction or nonreplacement of income-generating assets reduces the resettlers' ability to recover in a sustainable manner. For most small farmers, compensation of land in cash has proven to have ruinous effects and must be avoided in favor of land for land.

Costing and financing. A major finding of the resettlement study was that low resettlement performance is nearly always traceable to inadequate economic analysis, externalization of re-establishment costs to the affected population, and underfinancing. The incomplete recognition of the costs accruing to displaced people and the failure to internalize the full costs of resettlement in the overall project costs contribute directly to resettlers' impoverishment and distort the economic justification of some projects altogether.

Costs for compensation and resettlement can be a substantial component. A sample of 20 completed projects involving resettlement shows that resettlement averaged 9 percent of appraised costs. Resettlement costs tend to climb as high as 35 percent where high compensation payments are involved, large numbers of people are relocated, or the project undergoes a difficult resettlement process.

When resettlement costs are assessed incorrectly, local communities are forced to bear an undue share of the burden. Two problems are typical. First, compensation rates rarely reflect the true *replacement* value of lost assets, particularly for resettlers who must replace lost land. Depreciation of assets that must be replaced at market costs and property underassessments are both common. In India's Karnataka Irrigation, local courts raised compensation rates up to five times the value assessed by project officers, but only for those who could afford to bring a case. Recalculated costs for land acquisition and resettlement in Turkey's delayed Kayraktepe project went from an estimated $30 million in 1986 to more than $180 million in late 1993, an increase due partially to economic growth but primarily to initial underassessments of property values.

Second, delays in payments erode the real value of the compensation and force displaced families to go into debt to survive. Long delays in paying compensation are common. A case study in Nepal found an average delay of ten years between property expropriation and compensation payment. A 1992 Bank study of the Karnataka Irrigation project found families, displaced in the mid-1970s, that had yet to receive their compensation. In Ghana's Kpong project, governmental shortfalls meant that compensation was never paid to about 7,000 affected people and their host communities.

When the benefits of a project are delayed by one or more years, the economic rate of return can fall by several points. A one-year resettlement-caused delay in project benefits (with no delay in the schedule of project costs)

will reduce some projects' net present value by almost a third; a two-year delay, by more than half. Good economic reasoning suggests that the gains from avoiding such large losses are usually more than sufficient to finance the entire cost of resettlement.

Cost overruns for resettlement are often simple artifacts of initial underestimation of resettlement's true costs rather than, as some tend to interpret, the result of "gold-plating" resettlement components. The analysis of energy projects involving resettlement found that overall project cost overruns averaged 35 percent for hydroelectric dams and 10 percent for thermal power plants, while resettlement cost overruns averaged 54 percent. The analysis identified shortfalls in the initial financing of all energy projects reviewed.

More recent projects show a significant increase in per capita budget allocations for resettlement, reflecting better financial provisioning. On average, earlier projects (closed in the 1980s) are spending two to three times the per capita GNP of the given country on resettlement, whereas the later projects (started in the 1990s) spent three to five times. *Increased financing for re-establishing resettlers is a necessary and positive trend.* Dependable census at the outset should prevent unanticipated increases in the number of people to be resettled, which tend to pull down budgetary allocations per capita figures.

Poor resettlement can also undercut a project's other economic objectives. First, inadequate preparation can cause project delays, which in turn leads to foregone benefits, reducing the project's returns (see box). Second, in some cases, failing to account adequately for resettlement costs can exaggerate a project's attractiveness and, in extreme cases, can encourage economically marginal projects to proceed. Sound resettlement financing, on the other hand, can enhance a project's returns. It facilitates smooth implementation, and the increased incomes of resettlers can boost a project's rate of return.

Resettler's participation. It may seem paradoxical to advocate the "participation" of people in projects that seek to involuntarily displace them, yet securing such participation is essential. Participation takes several forms. The first is to inform the affected populations in time about the need to resettle, entitlements, eligibility, options, due process, and appeal mechanisms; next, these individuals and their organizations should be consulted about alternative options and solutions to avoid or minimize displacement, or to find suitable relocation sites. Many nongovernmental organizations (NGOs) have proven themselves to be effective in either mobilizing the energies of the resettlers for better implementation, or designing resettlement plans and realistic options, acceptable not only to the people but also to government authorities.

Time is money

Delays and cost overruns have contributed to driving down to very low levels the actual or expected economic rate of return of several resettlement projects. This was certainly the case for the World Bank's Gorgol Irrigation project in Mauritania, Subernarekha Irrigation project in India, and Guatape II Hydroelectric Project in Columbia. An excerpt from the Colombian project audit report shows that the underplanning and underfinancing of resettlement can become very costly:

". . . the resettlement and compensation of the individuals who were affected by inundation required lengthy negotiations, largely because the Borrower and the Bank failed to anticipate the complexity of the problem involved. . . . The final costs of the resettlement, in US$ equivalent, was more than double the original estimate and the process took about three years longer than envisaged. This delay, which in turn delayed the filling of the reservoir and storing of water energy, cost the economy the equivalent of . . . energy generation for an entire year."

The resulting electricity losses amounted to $25.5 million of unsold energy, equivalent to 18 percent of the total project cost.

Rethinking the Bank's role

The general conclusion of the resettlement review is that the quality of the Bank's resettlement project portfolio has improved, particularly since 1991. However, lingering weaknesses were identified. In response, the Bank has adopted three sets of measures to achieve further improvements in resettlement operations.

Strategic priorities. These include: (1) ensuring the borrower's commitment, by, among other things, making agreement on policy explicit from the outset and requiring the adoption of legal frameworks by borrowers for projects with large scale resettlement operations; (2) enhancing the borrower's institutional capacity through targeted institutional assistance, including special projects for building local organizational capacity for resettlement; (3) improving project design by avoiding or reducing displacement as much as possible, and by creating explicit timetables that link progress in civil works to the gradual advance of resettlement; (4) promoting people's participation; (5) providing increased Bank financing to future projects with resettlement, as well as supplementary financing to ongoing projects, when appropriate; (6) diversifying project vehicles, so that future infrastructural operations requiring the displacement of large numbers of people can be processed as twin projects—one for the civil works and another as a stand-alone resettlement project; and (7) strengthening the Bank's own institutional capacity.

Remedial and retrofitting actions. Near-term remedial actions are being taken in midstream in ongoing projects that fall short of policy and legal provisions, as well as in some recently completed projects; some projects may need substantial restructuring, additional financing, or the creation of resettlement agencies.

Improving project preparation and supervision. Improvements are being introduced in the analysis of resettlement at appraisal, in the design of development packages, in the in-house review of resettlement components, and in the staffing and organization of relevant operational units. The Bank will encourage borrowers to carry out pre-project pilot schemes to test the adequacy of proposed resettlement options. In major operations, especially for dams—resettlement advisory panels will be increasingly used. Supervision of projects including resettlement will be intensified (at least every 12 months) and the Bank will provide more technical assistance for improving the quality of resettlement.

As the attention of governments, donors, and the public shifts more and more to not only the environmental side of development but also to the *social* aspects, population displacement will increasingly grab the headlines as a painful toll of infrastructural investments. Indeed, the involuntary resettlement of millions of people worldwide will be a key item on the agenda of the March 1995 World Summit on Social Development in Copenhagen—the first summit to focus on the *social* consequences of economic growth. Clearly, population displacement urgently requires greater attention and resources, although even with such resources, it will remain a formidable challenge. The good news, however, as underscored by the Bank's study, is that this challenge can be met successfully. ■

For more details, see "Resettlement and Development: The Bankwide Review of Projects Involving Involuntary Resettlement 1986-1993," Environment Department, World Bank, April 1994. A detailed summary of this study is available in Spanish and in French.

Industrial and Developing Country Policy Linkages

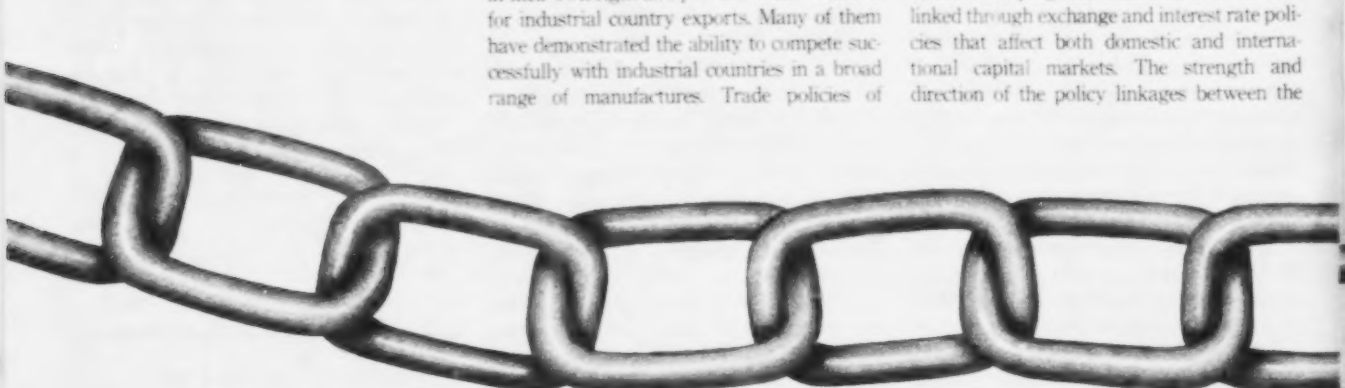
AZIZ ALI MOHAMMED

THERE ARE many channels through which industrial country performance affects the developing world. Yet with growing world economic interdependence, developing country performance may affect industrial country prospects as well. This argues for closer participation of developing countries in multilateral policy coordination.

It is customary to think of the interdependence of industrial and developing countries in a leader-follower context. Financial and exchange rate policies, labor market policies—including immigration controls—and a vast array of selective measures in the trade, agriculture, and industrial fields that serve particular sectoral interests have profound consequences for the economies of developing countries. Yet the underlying model of the world economy may be changing. Many developing countries have registered high rates of growth in recent years in the face of economic slowdown in the industrial world, and the rapid expansion of their markets is creating a growth impulse for industrial economies mired in recession. Moreover, emerging capital markets in some developing countries are opening up a range of new asset choices to investors in industrial countries as well, thereby binding developed and developing financial markets more closely.

Within this interdependence lies great diversity. The developing countries as a group are far from homogeneous—they are best visualized as strung along a development spectrum. Some of the middle-income countries have become important forces in the world economy in their own right and provide sizable markets for industrial country exports. Many of them have demonstrated the ability to compete successfully with industrial countries in a broad range of manufactures. Trade policies of industrial countries are thus of particular concern to them. As for international capital flows, only a select group of developing countries are able to attract private market funds while the remainder are still largely dependent on official flows. Indeed, the diversity within the developing world has reached a point where some countries are approaching industrial country status while others remain at, or even have regressed to, subsistence levels.

It would be premature to think of developing countries as the new locomotive of world growth. However, they might play such a role at critical cyclical turning points, when the margin of demand provided by rising exports to the developing countries could spell the difference between growth and the danger of recession persisting for one or more major industrial countries. In the United States, for example, the last recession would have persisted into 1991, and the recovery in 1991–92 would have been weaker, but for the strength provided by the increase in exports to the developing world (see chart). In addition to trade, developing and industrial countries are linked through exchange and interest rate policies that affect both domestic and international capital markets. The strength and direction of the policy linkages between the



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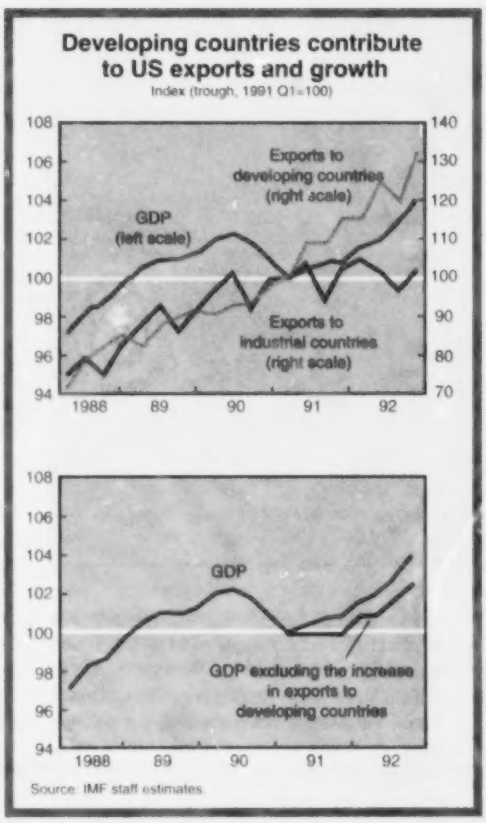
developed and developing worlds are changing subtly but perceptibly. However, the industrial world still remains the dominant partner by far.

Trade policy linkages

Trade policies represent one of the most direct links between industrial and developing country economies, and trade barriers can blunt growth potential for both groups. Developments in industrial country trade policies during the past decade present a mixed picture—tariffs, with some exceptions, have ceased to be a significant barrier to trade, but trade tensions have nevertheless grown. A more activist trade policy stance adopted by many industrial countries has resulted in significantly greater use of nontariff barriers and more frequent recourse to instruments of contingent protection. While many of these measures have been aimed at trade within industrial countries, they have also affected developing countries, especially in East Asia.

Nontariff barriers that affect developing countries are most extensive in agricultural products and textiles and apparel. For example, a recent World Bank study shows that nontariff measures cover as much as 80 percent of Bangladesh's exports to OECD countries, 65 percent of OECD imports from Pakistan, and over 50 percent of OECD imports from Thailand (Table 1). Removal of these barriers could result in important export gains for a number of developing countries.

Other measures that restrict trade include voluntary export restraints and other managed trade arrangements as well as antidumping and countervailing duties that provide contingent protection. Even when these instruments are consistent with the General Agreement on Tariffs and Trade (GATT), invoking them frequently discourages new entrants into export markets. Developing countries affected by these measures have included Brazil, China, Korea, Singapore, Taiwan Province of China, and Thailand.



The prospect of the rapid proliferation of regional trading arrangements also affects the policies that link developed and developing countries because it raises concerns about the potential of these arrangements to fragment international trade. It has been estimated that almost one half of world exports may be covered by existing or proposed preferential trade arrangements, including the North American Free Trade Agreement (NAFTA) and its possible expansion, and the extension of the European Union arrangements to much of the rest of Europe. The basic concern is that these developments might, in some instances, discourage open multilateral trade and thereby have a negative effect on countries excluded from the regional groups.

Another set of concerns arises from the implicit coercion that developing countries may face to satisfy the claims of environmental, labor, and other interests in industrial countries. Environmental protection and labor welfare standards that are affordable in high-income countries may undermine the basis for comparative advantage in poorer countries.

In recent years developing countries have increasingly adopted market-oriented, trade-promoting policies on the premise that an external environment of unrestricted trading opportunities and access to markets and resources would be maintained. Thus, any backsliding in the trade area by industrial countries would seriously damage the ability of developing countries to pursue open market policies and, ultimately, hamper world growth prospects.

Global capital markets

The capital account relationship between industrial and developing countries in the postwar period has been characterized by significant changes: the share of foreign direct investment has increased sharply; and, although official development assistance and lending by multilateral financial institutions have remained large, private capital flows have achieved an almost equal share in recent years as bonds and equity investments have gained in importance (Table 2).

There is controversy about how much of this change is attributable to *push* factors—policies and circumstances in the industrial countries—and how much to *pull* factors—better policies and improving conditions in the recipient countries. An IMF study of capital inflows in ten Latin American countries (see "Capital Inflows and Real Exchange Rate Appreciation in Latin America," by Calvo, Leiderman, and Reinhart, *IMF Staff Papers*, Vol. 40, 1993) concluded that external factors contributed to about half of the inflows, especially following the onset of recession in 1989 in the United States. Other external developments included regulatory changes in the United States that resulted in a reduction in transaction costs and in liquidity requirements for countries tapping the US capital markets; large-scale turmoil in the Middle East, which probably motivated a relocation of regional savings; and actual or

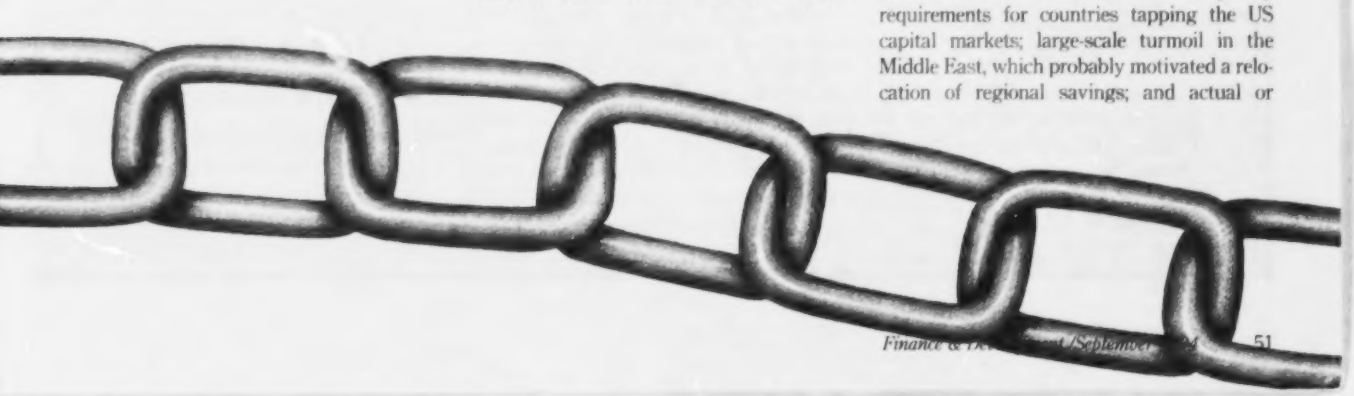


Table 1

Trade barriers reduce export potential

	Average tariffs and nontariff barriers in OECD countries		Estimated effect of trade barrier removal [1]	
	Average OECD tariff (percent)	Percent of imports covered by nontariff measures	Exports to OECD (million dollars)	Percentage increase
Bangladesh	9.9	80.5	985	104
Dominican Republic	9.9	38.3	1,712	96
Haiti	11.2	16.7	421	100
India	2.3	46.2	3,123	35
Jamaica	6.2	43.7	555	62
Malaysia	2.2	40.8	1,943	16
Pakistan	3.5	65.6	1,492	58
Philippines	5.7	35.9	2,820	44
Sri Lanka	8.3	63.9	1,016	105
Thailand	3.3	51.4	4,613	43

Source: *Global Economic Prospects and the Developing Countries*, pp. 50–61, World Bank, 1993.
[1] For details on assumptions underlying the above estimates, see Appendix C of 1992 World Bank report, *Global Economic Prospects*.

prospective changes in regional trading arrangements, represented, for example, by the passage of NAFTA.

As for pull factors, capital inflows were clearly attracted to developing countries that successfully stabilized their economies and followed up with far-reaching structural reforms.

Better policymaking. The better investment climate in many developing countries reflects in part the radical improvement in the quality of their policymaking. For the strong performers, economic reform has reduced public dissaving and raised private saving at a time when budgetary deficits have been on the rise in industrial countries. In a sense, some developing countries could claim to be outperforming the countries to which their own currencies are linked. Similarly, structural reforms in the trade, investment, and financial market areas have lowered the cost of capital while promoting efficient resource mobilization and allocation.

Improved creditworthiness. A part of the improvement illustrates the beneficial effects of cooperation between creditors and debtors, both official and private. Debt-reduction operations have improved the creditworthiness of a number of heavily indebted countries, leading to a rapid decline in risk premiums, as indicated by lower spreads on international capital markets. Better creditworthiness is also demonstrated by the success of extensive privatization programs in attracting large inflows of foreign capital and capital held abroad by domestic residents.

Exchange rates

Developing countries have also been affected by changing cross rates among the major international currencies and the prospect of further changes from the recent widening of margins for fluctuation or, in some cases, their temporary abandonment. The most direct effect is transmitted through the pegs that a substantial number of these countries maintain to the major currencies. Changes in exchange rates can induce changes in trade flows, although these effects may emerge only gradually. Even where the peg is to a basket of currencies, changing exchange rate relationships within the basket produce movements that might require changes in the peg itself.

Another set of effects arises when the currency composition of debt-servicing obligations does not match the currency composition of a country's export receipts. This is most clearly apparent in countries that have significant liabilities not denominated in US dollars but whose export earnings are denominated predominantly in US dollars, as in the case of oil and other primary commodity producers. The effects are by no means uniform; they depend upon the currency composition of the outstanding debt, whether the debt is at fixed or adjustable interest rates, and its maturity pattern, among other variables.

Interest rate changes associated with exchange rate fluctuations can amplify these disturbances. In countries where private sectors have access to international capital markets, the overall liability position, as well as sovereign external liabilities is affected. Financial derivatives have enabled hedging of certain risks, and private firms in developing countries have generally been quick to take advantage of such facilities. Nevertheless, to the extent that exchange and interest rate risk is increased by fluctuations in the exchange rate relationships among the major currencies, the cost of external liability management is intensified.

Fiscal policies and real interest rates. Because of their impact on the debt-service burden of developing countries and on the relative attractiveness of investing in emerging financial markets, developments in real interest rates in industrial countries' capital markets are especially important for the economies of developing countries.

In the past decade, fiscal imbalances have influenced the level of real interest rates prevailing in industrial countries. These rates averaged 4–7 percentage points higher in the 1980s than in earlier periods of low inflation when real interest rates in most industrial countries averaged 1–3 percent. Many reasons have been advanced for the higher real rates in the 1980s, including the rise in the ratio of gross public debt to nominal GDP from about 40 percent for the seven largest industrial countries in 1970 to over 63 percent in 1992. Although the effect of accumulating government debt on real interest rates is by no means a settled issue, empirical evidence does suggest the impact is significant when high fiscal deficits are combined with a tightening of monetary policy, such as happened toward the end of the 1970s in the United States. Even after monetary policy moved back to a more accommodative stance at the turn of the 1980s, the resultant decline in nominal interest rates did not produce an equivalent decline in real interest rates.

With public indebtedness continuing to rise relative to GDP, one might expect long-term rates to remain higher in the 1990s than the levels prevailing in the 1960s and the first half of the 1970s. Model simulations by the staff of the World Bank indicate that, everything considered, developing countries could lose between 0.5 percent and 1 percent a year of income growth over the medium term as a consequence of continued high real interest rates.

A prognosis of this kind emphasizes the direct concern of developing countries in the mix and stance of industrial country macroeconomic policies. This concern is intensified in the face of longer-range issues raised by aging populations and other financial commitments of industrial countries, especially those relating to the support of farm incomes and health care costs.

How strong are linkages?

Developing countries' economic performance has improved over the past decade, suggesting that they may have a larger role to play than in the past in shaping policies that link industrial and developing countries. While this

may be true to some extent, the influence of developing countries on the industrial countries is still relatively mild and intermittent, compared to that of the industrial world, and is confined to a select subset of the developing countries. This is primarily because the industrial countries, whose weight in the global economy is predominant, largely shape the external environment in which the developing countries can best grow and prosper. The principal elements of this environment—industrial country growth, as it affects demand for developing country exports; access to export markets; real interest rates and the terms of external finance; exchange rates; commodity prices and the terms of trade—are likely to remain largely beyond the control of developing countries.

Especially vulnerable are the poorer countries that depend heavily on concessional funding for their development. These countries are the most sensitive to the effects of budgetary policies in donor countries. Their concerns have intensified with the appearance of new claimants in Eastern Europe and the states of the former Soviet Union for aid funds that are not growing commensurately and may even be shrinking in real terms. Of equal concern are additional capital requirements to meet the demand for environmental safeguards that are being pushed increasingly as conditions for aid.

Most worrisome is the question of whether the higher growth now being registered in certain parts of the developing world as a direct consequence of policy improvements can be maintained if the current uncertainties in the global economy persist or worsen. There is little doubt that if protectionist pressures in industrial countries were to intensify, the ability of developing country policymakers to continue pursuing market-oriented reforms would be gravely weakened.

But it is not only in the trade area that these linkages apply. As the preceding analysis has indicated, developing country performance is affected by the macroeconomic policies of the industrial countries through several channels. A greater regard for the implications of industrial country macroeconomic policies for developing country performance is thus not a matter of altruism. Rather, there is a need to recognize the fact that this performance is not only affected by, but also directly affects, the prospects for recovery and growth in the industrial world. In a world economy where downside risks abound, an urgent task for the international community must be to draw attention to these interdependencies. ■

Table 2
Capital flows to developing countries[1]
(percentage share in total)

Types of finance	1971–76	1977–81	1982–88	1989–92
Foreign direct investment	10.8	8.5	10.6	17.7
Portfolio equity	--	--	--	3.3
Bonds	1.4	2.5	3.1	5.7
Commercial bank loans	35.8	43.5	27.9	18.2
Supplier and export credits	9.2	10.3	11.7	11.4
Official loans	30.9	26.4	35.7	31.9
Grants	11.9	8.8	10.8	13.8
Total (percent)	100.0	100.0	100.0	100.0
Total (billion dollars)	41.2	110.9	125.5	175.3

Source: IMF staff estimates.
1 Gross long-term flows.
--: Data not available.

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Is Trade Between the United States and Japan Off Balance?

STEPHEN S. GOLUB

CONTRARY to popular views, an IMF study shows that Japan's current account surpluses are a reflection of trends in saving and investment rates rather than predatory behavior of Japanese producers and government. Moreover, Japanese trade patterns appear to be as responsive to market forces as those of other major industrial countries.

"If the [trade] balance would be in favour of France, it would by no means follow that such a trade would be disadvantageous to England....If the wines of France are better and cheaper than those of Portugal, or its linens than those of Germany, it would be more advantageous for Great Britain to purchase both the wine and the foreign linen which it had occasion for of France, than of Portugal and Germany....Nothing can be more absurd than this doctrine of the balance of trade, upon which almost all [trade barriers]...are founded."

Adam Smith, *The Wealth of Nations*

As in Adam Smith's time, many view trade balances as a sign of national power, score cards in the conflict between nations. Japan's manufacturing trade surpluses, in particular, have caused much consternation in the United States. Many policymakers and commentators blame US trade deficits on barriers to imports in Japan, predatory behavior by Japanese producers, and overly dedicated Japanese workers. Japanese commentators often respond with criticisms of US work habits and the US educational system. Although they disagree on the validity of these various incriminations, most economists would view them as largely irrelevant to the determination of overall and sectoral trade balances. There is legitimate controversy over the degree of openness of the Japanese market, but this has little bearing on trade balances.

What, then, are the factors behind overall and sectoral trade surpluses and deficits and what is the alleged role of Japanese barriers? Economic theory suggests that trade balances by sector are influenced by both macroeconomic and microeconomic factors. The overall current account balance is determined by macroeconomic factors, namely the level of aggregate demand in relation to output (or equivalently the relation between saving and investment), as well as the degree of international capital mobility. Shocks to aggregate demand and supply are transmitted to the current account through real exchange rates and relative outputs, although the former operate with a substantial lag.

At the microeconomic level, sectoral trade deficits and surpluses are influenced by comparative advantage: those sectors with particular advantages relative to other industries and other countries—in the form of either higher productivity, lower costs, and government aid—will tend to be net exporters even when a nation's overall trade balance is zero. Those at a comparative disadvantage will, of course, tend to be net importers. But sectoral trade balances also reflect the macroeconomic factors discussed above, as the overall current account balance must manifest itself in individual sectors. In particular, real exchange rate changes alter absolute advantage (i.e., the competitiveness of all sectors is affected simultaneously). For example, if the US dollar appreciates in real terms, industries in which the United States has a comparative advantage will experience declines in their sectoral surpluses, and some may even move into deficit, while sectors where the United States has a comparative disadvantage will suffer greater deficits. The combined effect of these sectoral effects is a larger overall current account deficit.

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Table 1

Deficits and surpluses

Trade and current account balances

(annual averages, billion dollars)

	1970–80	1981–83	1984–87	1988–90	1991–92
US current account	0	-17	-133	-106	-33
US trade balance	-12	-44	-135	-117	-85
Japan current account	2	11	64	57	95
Japan trade balance	6	23	72	78	118
Bilateral US-Japan trade balance	4	15	46	44	41

Sources: *International Financial Statistics* and *Direction of Trade Statistics*, IMF.

Overall current account balance

The most meaningful measure of a country's net international transactions is the overall current account. The merchandise trade balance omits the increasingly important role of trade in services. Bilateral trade balances should not be a cause for concern, as the quote from Adam Smith suggests. To update Smith's example, Japan could have a bilateral deficit with oil-exporting countries, while it has a surplus with the United States, all of which reflects Japanese comparative advantage. The popular fixation on bilateral merchandise trade balances is therefore misguided on both counts.

The current account balance of a country is identically equal to the difference between national saving and investment, and is also equal to the net lending or borrowing of that country. For example, a country with a current account deficit is necessarily incurring liabilities or selling off assets to finance this deficit, and its investment exceeds its saving by an amount which is equal to the funds raised from other countries. These net capital flows could have favorable effects through a more efficient global allocation of resources over time. The creditor countries receive a higher return on their saving than they would if confined to domestic investment opportunities, whereas the borrowing country is able to obtain funds for investment or consumption at lower costs than otherwise. If the country's investment prospects are attractive due to a strong outlook for long-run growth and sound policies, the resulting net capital inflows (and current account deficit) can be regarded as a sign of national strength rather than weakness. On the other hand, if the current account balance reflects an unsustainable consumption boom caused by inappropriate macroeconomic policies, it is likely to be detrimental. The welfare effects of current account balances cannot be assessed independently of their overall macroeconomic context. This article will not attempt to pass judgment on US and Japanese macroeconomic policies, however.

The US current account deficit swelled in the mid-1980s and then receded steadily until 1992, when it began to increase again. At the same time, as Table 1 shows, the Japanese current account balance followed the opposite pattern, rising sharply in the mid-1980s, dropping until 1991, then increasing again in 1991 and 1992. The trade balance shows more pronounced movements for both countries than the current account, because the United States has an increasing surplus and Japan an increasing deficit in private services that more than offset the net decline in US investment income associated with the increasing net debtor position. Unilateral transfers associated with the Gulf War also contributed to a temporary reduction of the US current account deficit.

What are the causes of the US current account deficits and Japanese surpluses?

Table 2

Macroeconomic factors help explain variations in current account balances

(percent of net national product)

	1960–73	1974–79	1984–90
United States			
Private saving	10.2	10.1	7.4
Government budget	-0.9	-1.5	-3.7
Private investment	9.4	9.8	5.6
Current account	0.6	-0.1	-2.9
Japan			
Private saving	19.2	15.8	12.0
Government budget	2.1	-4.0	1.6
Private investment	20.9	11.2	9.9
Current account	0.6	0.9	3.5

Note: Numbers may not add up due to statistical discrepancies.

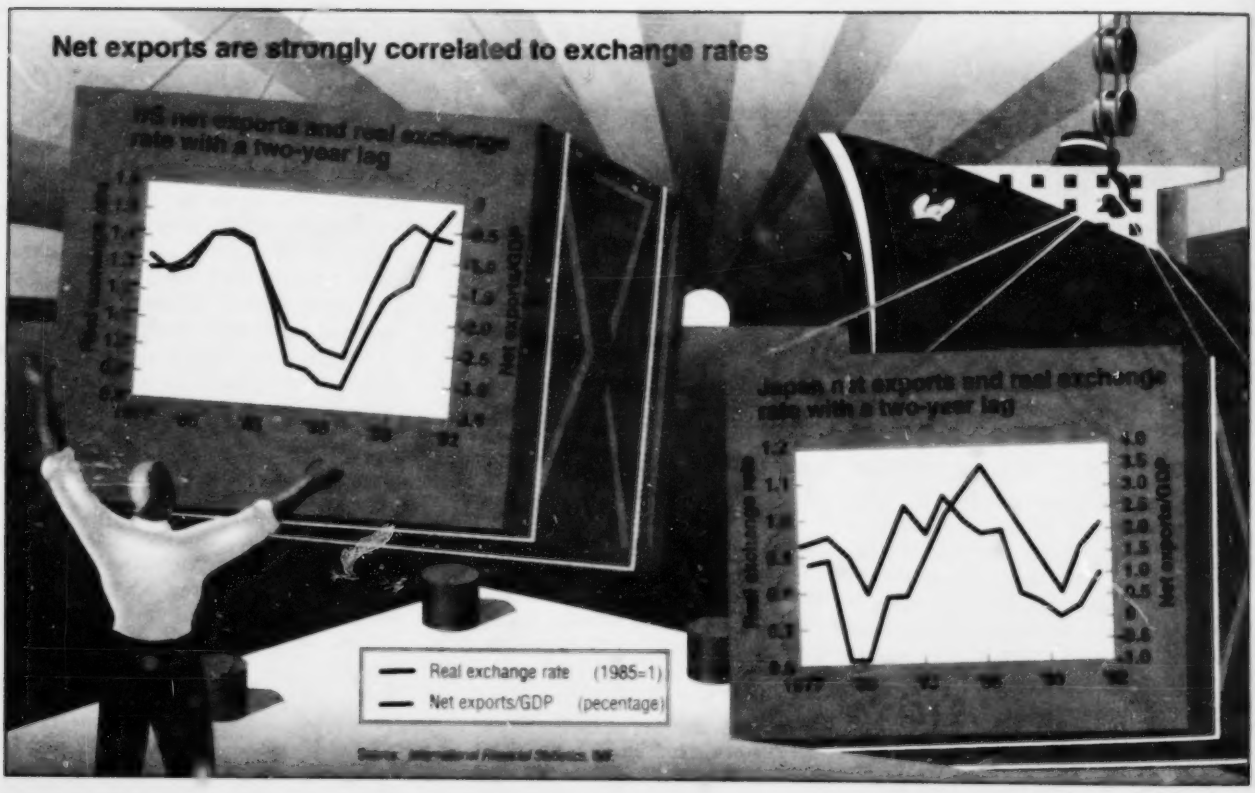
Source: Barry P. Bosworth, *Saving and Investment in a Global Economy*, The Brookings Institution, Washington, DC, 1993.

Clearly, the explanation must be specific to the 1980s, because these sustained current account imbalances were not in evidence before then. It seems very difficult to argue that Japanese trading practices explain these current account patterns, since such an explanation would be valid only if Japan had, contrary to all available evidence, significantly increased its barriers to imports or subsidies to exports. If anything, Japan liberalized its trade policies in the 1980s, while the United States may have increased its protection.

There is near unanimity among economists that macroeconomic factors help explain variations in current account balances both in theory and in practice. First, declining national saving in the United States in the early 1980s, primarily due to public sector dissaving, caused an excess demand for goods in the United States, or equivalently, a shortfall in national saving relative to investment, thereby driving up real interest rates in the United States. Table 2 reviews the familiar evidence on saving, investment, and the current account for the United States and Japan. In both countries there have been declines in both private saving and investment rates since the 1960s. The current account balances in the 1980s are mainly the counterpart of divergent movements in government budget balances rather than private saving and investment.

Second, in an environment of increasing international capital mobility, these higher real interest rates allowed the United States to finance its current consumption by running up a large foreign debt, in addition to some crowding out of private investment. Third, other shocks in the early 1980s, such as tight US monetary policy and a portfolio shift toward dollar assets, may also have contributed to real exchange rate appreciation and current account deficits. To varying degrees, these shocks were partially reversed in the late 1980s, resulting in declining real interest rates in the United States, depreciation of the dollar, and reduced US current account deficits. Finally, more recently, in the early 1990s, recessions in Japan and Western Europe, combined with recovery in the United States, have resulted in a renewed worsening of the US current account deficit.

Medium-term macroeconomic shocks are transmitted to the current account primarily through the real exchange rate. The link between exchange rates and trade flows has been studied at length, and, after some controversy in the late 1980s, a near consensus has reemerged that trade flows respond in a pre-


Net exports are strongly correlated to exchange rates
US net exports and real exchange rate with a two-year lag
Japan net exports and real exchange rate with a two-year lag
Real exchange rate (1985=1)
Net exports/GDP (pecentage)

dictable fashion to real exchange rate changes. Charts 1 and 2 indicate a strong correlation of US and Japanese net exports to exchange rates after allowing for a two-year lag. The controversies over the adequacy of the adjustment mechanism in the late 1980s seem to have arisen mainly from disregard of the normal long lags, and the failure to distinguish between nominal and real trade flows. In particular, the appreciation of the yen entailed a large increase in Japanese import volume, but the fall in Japanese import prices dampened the growth of nominal import values. It is important to recognize, however, that the exchange rate is not an independent instrument at the disposal of the authorities; it is an endogenous variable that adjusts to the types of shocks discussed above.

Openness of Japanese market

Contrary to popular views, the trade balance is a macroeconomic phenomenon and has little to do with degrees of protection. In equilibrium, low imports also imply low exports, given the saving-investment balance. If Japan were to import more, it would eventually also export more. Trade barriers only affect the trade balance if they have significant fiscal implications that alter national saving and investment, which seems unlikely in the Japanese case since overt barriers are low. Similarly, deregulation in Japan would contribute to reduction of Japanese trade surpluses if it resulted in a decline in domestic saving or an increase in domestic investment. Even if it has little effect on the trade balance, the level of protection in Japan may still matter to Japan's trading partners for other reasons, both political and economic. The perception that the Japanese market is closed may adversely affect the willingness of other countries to pursue liberal trade policies. Japanese barriers could also cause other countries' terms of trade to deteriorate, although the magnitude of this effect is unclear.

Overt Japanese protection in the form of tariffs and quotas is perhaps lower than protection in most other industrial countries, except in agriculture.

The importance of invisible barriers to the Japanese market is more controversial. There are numerous anecdotes and case studies reporting substantial intangible barriers to the Japanese market, but it is difficult to assess their significance systematically. Japan has an unusually low volume of manufactured imports and intra-industry trade, and the level of inward foreign direct investment in Japan is much smaller than in other industrial countries. A number of studies have attempted to determine if Japan's level and pattern of trade are abnormal, after controlling for country characteristics such as size, location, and natural resource endowment. These studies have arrived at conflicting conclusions, with most finding that Japan's imports of manufactures are unusually small and others finding both that Japan's total trade is normal and that Japanese trading patterns are consistent with Japan's factor endowments.

Another approach to the issue of invisible barriers is to examine differences in prices of similar goods in Japan and elsewhere, since these might indicate implicit protection. The evidence is again ambiguous. Moreover, the macroeconomic evidence on the impact of exchange rate changes poses a challenge to those who argue that Japanese trade is not responsive to market forces at the microeconomic level.

Sectoral balances

As noted above, sectoral trade balances are affected by both microeconomic and macroeconomic factors. The classical Ricardian model of trade provides a simple framework with which to analyze these effects. The basic idea is that relative unit labor cost—the centerpiece of the Ricardian model—is influenced both by sector specific variables (productivity

Table 3

Much of Japan's trade is consistent with relative unit labor costs

(sectoral relative unit labor costs and intra-G-7 trade balances)

United States

	Relative unit labor costs [1]				Trade balance [2]			
	1970	1980	1985	1989	1972	1982	1987	1991
Manufacturing	1.32	1.00	1.20	0.93	-3.4	-6.0	-13.0	-6.7
Agriculture	0.62	0.51	0.61	0.58	2.7	3.9	2.3	7.2
Manufacturing sectors								
Machinery	1.37	1.03	1.21	0.92	-3.3	-8.4	-22.4	-13.0
Textiles	1.47	0.96	1.18	0.93	-5.4	-2.3	-7.8	-1.9
Nonmetallic minerals	1.34	0.97	1.22	0.93	-2.3	-4.8	-7.5	-4.0
Paper	1.22	0.95	1.11	1.02	-3.7	-4.0	-5.2	-2.7
Basic metals	1.24	1.12	1.43	1.14	-10.9	-32.1	-20.2	-9.9
Chemicals	1.24	0.98	1.25	0.96	0.5	-0.6	-4.2	-1.7
Food	1.47	1.06	1.23	0.96	-0.1	0.1	0.4	3.8

Japan

	Relative unit labor costs [1]				Trade balance [2]			
	1970	1980	1985	1989	1972	1982	1987	1991
Manufacturing	0.66	0.65	0.67	1.11	6.4	8.9	10.9	6.3
Agriculture	1.48	1.69	1.70	2.05	-4.9	-16.5	-11.9	-15.4
Manufacturing sectors								
Machinery	0.84	0.87	0.85	1.04	13.2	24.7	28.3	18.0
Textiles	0.85	1.22	1.39	2.22	10.9	-4.2	-4.2	-17.0
Nonmetallic minerals	0.59	1.10	0.96	1.29	4.4	3.4	2.3	0.5
Paper	0.61	0.84	0.80	0.96	-6.4	-11.6	-7.6	-6.9
Basic metals	0.46	0.47	0.63	0.62	9.4	8.5	3.5	-0.7
Chemicals	0.61	0.67	0.60	0.66	-0.8	-6.0	-1.8	-2.6
Food	0.48	0.71	0.86	1.24	-1.9	-8.0	-6.5	-8.6

Source: Organization for Economic Cooperation and Development.
[1] Unit labor cost divided by G-7 average unit labor cost.
[2] Intra G-7 trade balance divided by sectoral value added, in percent.

and wages) and by the real exchange rate. For example, the automobile sector in the United States could be under pressure from Japanese imports because of some combination of (1) higher Japanese productivity in autos, (2) US auto workers' wages are above the US average wage, (3) overall US wages are out of line with productivity, and (4) the dollar is overvalued.

An IMF study (see reference) analyzed the time series and cross-sectional behavior of relative unit labor costs, and correlated these costs with sectoral trade balances. Table 3 reports US and Japanese relative unit labor costs, expressed as a ratio of average unit labor costs for the seven largest industrial countries (G-7). Both productivity and exchange rate variations affect the results. Japanese overall productivity grew rapidly relative to other countries in recent decades, but had an unusually high dispersion across sectors. For many sectors, in the late 1980s, Japan's productivity remained well below that of the United States and the G-7 average, but in a few manufacturing sectors, Japan had the highest productivity of the G-7 countries. US productivity in agriculture and aggregate manufacturing remain well above those of other G-7 countries.

The effects of exchange rate movements are evident for all categories of US trade. For example, US total manufacturing unit labor costs are high in 1970 and 1985, periods when the dollar was relatively strong, but in 1980 and 1989 the opposite is true. By 1989, US manufacturing unit labor cost was below the G-7 average.

Japan's comparative advantage in manufactures is reflected in relative unit labor cost below 1.0 until the late 1980s, when the strong yen overwhelms the continuing underlying competitiveness of Japanese manufactures. The dispersion in manufacturing productivity for Japan is reflected in its unit labor costs.

Intra-G-7 trade balance data for the same sectors and countries is also shown in Table 3. The trade balances have been scaled by sectoral value added, and shown with a two-year lag with respect to the years for which unit labor cost data are shown, to allow for the typical lag uncovered at the aggregate level. The US comparative advantage and Japanese disadvantage in agriculture manifested themselves in structural US surpluses and Japanese deficits. Similarly, the low Japanese unit labor cost in manufacturing (until the late 1980s) and the generally high US counterpart (with the exceptions of sharp dollar depreciations in the late 1970s and the late 1980s) are consistent with Japanese structural surpluses and US deficits in manufacturing. At a more disaggregated level, many of the results also make sense, although there are some anomalies, which may be due to factors not considered here, such as raw materials and product quality.

Statistical analysis confirms that Japanese sectoral trade balances are at least as responsive to relative unit labor costs as those of other G-7 countries. The finding that much of Japan's trade is consistent with relative unit labor costs complements other research using factor endowments-based approaches to comparative advantage. That is, technological differences and factor endowments are both important in explaining Japan's comparative advantage.

Adam Smith was right

In the United States and Europe, it is widely believed that Japanese trade surpluses are harmful to Japan's trading partners. From a macroeconomic perspective, there is nothing surprising about Japan's surpluses. Declining US national saving rates relative to Japan naturally entailed capital outflows from Japan and capital inflows into the United States, which had their counterparts in Japanese current account surpluses and US deficits. The fact that macroeconomic factors have determined the current account imbalances raises the important question of whether macroeconomic policies have been appropriate, a topic which is beyond the scope of this article.

At the sectoral level, Japan's intra G-7 trade balances are explained relatively well by sectoral relative unit labor costs, although there are some anomalies for all countries. This does not mean that protection is nonexistent in Japan, but it does suggest that the extent to which trade patterns are determined by comparative advantage is greater for Japan than for most other major industrial countries. Consequently, the results reported here provide no support for the view that Japan's sectoral trade balances must be "managed" because Japanese trade is not responsive to normal market forces. If France is substituted for the United States, and England with Japan, Adam Smith's critique of mercantilism is as relevant today as it was in 1776. ■

This article is based on two longer papers by the author: "Comparative Advantage, Exchange Rates, and G-7 Sectoral Trade Balances," IMF Staff Papers, *June 1994 and "The United States-Japan Trade Balance: A Review," IMF Paper on Policy Assessment and Analysis (PPAA/94/8).*

The Long and Winding Road: Toward Freer World Trade

PATRICK LOW AND JOHN NASH

AT A TIME when many developing countries are moving toward more open trade policies, there are still signs of strain in the trading system, fed by protectionist pressures. A more open, globally oriented trade regime—effectively integrating national economies into a global market—requires continued reform efforts by both industrial and developing countries.

For more than a decade, growth in world trade has outpaced growth in world GDP. For countries that adopted outward-oriented policies, the benefits were considerable. The high-performing economies of East Asia, for example, greatly increased their share of world manufactures exports, while enjoying GDP growth rates from 1965–1990 roughly three times that of Latin America and South Asia and five times that of Sub-Saharan Africa. Most of the developing countries in these other regions, by contrast, were following import substitution policies.

This trade explosion—together with the manifest failure of the model of import substitution elsewhere—has led to a broad agreement among the development community on the virtues of forging stronger trade links between the developing economies and the rest of the global economy. In keeping with this outlook, many developing countries, eager to enjoy the benefits of expanding international trade, have implemented trade policy reforms—reducing controls on imports and exports, lowering and unifying tariff rates, and making foreign exchange systems more market-driven—as a major element in their economic programs.

But there is still some resistance to free trade that could threaten the trading system. In particular, while many countries have pushed hard to expand exports, they have only reluctantly lowered barriers to imports. This reluctance to open may be fed by the failure to realize that the benefits of a global market come from the consumption of imports that are available more cheaply, of better quality, and in far greater diversity on world markets than in any single domestic market. And while the production of exports can be a source of technology transfer and jobs, their main role is to provide foreign exchange to pay for imports.

Unfortunately, the countries of the Organization of Economic Cooperation and Development (OECD) have set a poor example for developing economies by maintaining nontariff barriers to imports despite admonishments to developing countries to do just the opposite. In addition, the philosophy of the General Agreement on Tariffs and Trade (GATT), to which many developing countries acceded in the 1980s, often seems to be based on the notion that the benefits derive from increasing exports, and that the lower import barriers are a price that needs to be paid. Further, economists have not been very successful in selling the "Lerner symmetry" notion, which argues that restricting imports is bad for exports as well.

Undoubtedly, today's world is a friendlier environment for trade—both imports and exports—than it was in the early 1980s. But how much friendlier? And what remains to be done to continue lowering barriers and avoid the erection of new ones? A look at the progress to date reveals that many issues still need to be addressed—old issues that were never fully resolved as well as emerging issues that need to be overcome.

What has been done

To what extent have trade reform policies been put in place? Progress in some regions can be considered dramatic. During the 1980s, many Latin American and Caribbean countries undertook far-reaching and fundamental trade reforms (see "Trade Reform in Latin America and The Caribbean," in *Finance & Development*, September 1993). With some exceptions for natural resource-based products, controls and taxes on exports have been removed. On the import side, a number of countries have followed the example of Mexico, which used to have one of the most highly regulated trade regimes, but now has one of the most liberal. Only a few nontariff barriers (NTBs) remain, with a top tariff rate of around 20 percent. The Caribbean Community has announced plans to follow suit by 1994–95. Chile, the Hemisphere's star performer in terms of export and GDP growth, has no nontariff barriers and a uniform tariff of 11 percent. In addition, most of the Latin American and Caribbean countries

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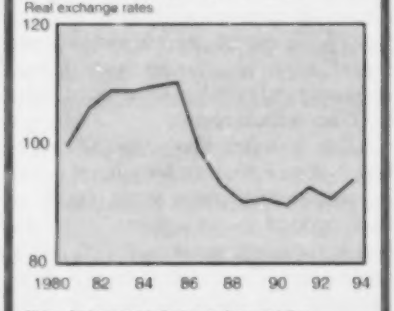
have well-functioning and open foreign exchange markets, without administrative allocation of foreign exchange.

Sub-Saharan Africa, however, is another story. While most countries in this region have undertaken some trade policy reforms, no country has come close to the record of the Western Hemisphere. Even among the brightest stars—Mauritius and more recently Ghana, for example—tariffs remain high, though they are distinguished from many other African countries by their liberal foreign exchange regimes and, as in Mauritius, a well-established export development system. In other countries, only minimal progress has been made in lifting some restrictions on trade, as governments have been unable to relinquish control over foreign exchange allocation, and fiscal problems have been an obstacle to tariff reduction. Studies estimating the effective rate of protection indicate a reduction in the "tariff equivalent" of protection of 40 percentage points, a relatively modest reduction considering the severity of the initial distortions in regimes where maximum tariff rates and black market premia ranged into the hundreds of percent.

The record of trade reforms in Asia is quite mixed. In East Asia, some countries (Hong Kong and Singapore) have been free-traders for many years. Others have long had successful export policies and have gradually but strongly moved to open up to imports. (Korea and Malaysia have average tariff rates of about 10 percent and almost no NTBs.) All these countries have been very successful in maintaining macroeconomic stability and avoiding overvalued exchange rates. In most of South Asia, on the other hand, there is still some resistance to reforms. NTB coverage is extensive and tariff rates extremely high. India recently floated its currency, but did not change the licensing requirements that apply to all imports of consumer goods.

For most of the economies in transition from socialism, the starting point is very different from those of developing countries in the early 1980s. The transition economies generally have low tariffs and few formal restrictions on imports (indeed, some imports have been heavily subsidized). Instead, these economies have direct restrictions on exports—a response to shortages of key inputs. This, of course, has the automatic effect of discouraging imports as well through undervaluation of the currency (Lerner symmetry again), an effect usually reinforced by foreign exchange rationing and monopolistic state trading organizations. In Eastern European countries and republics of the former Soviet Union, export restrictions have been reduced, but not eliminated. Major problems remain in the foreign exchange markets, even in countries that supposedly have market-determined rates. Romania, for instance, has an auction system, but the price of foreign exchange has remained fixed for long periods of time. And as countries have reduced export controls and the exchange rates have appreciated, there has been increasing pressure on domestic producers, with a consequent rise in tariffs on competing imports. A few countries (notably Estonia, where tariffs are negligible) have succeeded in making a transition to a trade regime with both few export controls and taxes and relatively low import tariffs.

How much progress?
Real exchange rate movements in the developing countries
(1980=100, unweighted average)



Note: An increase indicates real appreciation.
Source: IMF data.

Thus, many developing countries have been moving in the right direction toward more open trade regimes and have made more progress than many would have thought possible a decade ago. A good indicator of progress (both in the short and long run) is the real exchange rate. Successful trade policy reforms have almost always been associated with significant depreciations of the real exchange rate. And in the long run, the real exchange rate evolves as an outcome of (among other things) the openness of the trade regime. By this index, most developing countries have more open regimes now than in 1980, though most of the progress was made between 1985 and 1988 (see chart).

But many of these countries still have a long way to go. Quantitative controls on exports and imports are still common and tariffs are still very high compared to those in the OECD countries, which average around 5 percent. Most developing and transition countries still have currency controls. Resistance to reform has perhaps been the greatest in the agricultural sector, where protectionist barriers have been erected even in otherwise liberal countries (as is also true in the OECD). Mexico has plans to replace all trade and price-related interventions in agriculture with direct income support, which could make it a leader in reform in this area.

Further, there is still a large agenda of reforms related to structural and administrative factors influencing trade, which assumed greater importance in some countries once the overt barriers were reduced. These include structural problems relating to trade-supporting services (such as ports, transport, insurance, and communications) and inefficiency and corruption in customs and other government agencies involved in trade regulation.

Issues to resolve

Whether modest or sweeping, brand new or longstanding, trade policy reforms are unpopular with some of the population and there will always be pressure for their reversal. This pressure is magnified by the one-sided view of

the benefits of trade, which sees imports as a cost, not as a benefit. Especially in the current international environment, where policies are more constrained by GATT commitments and pressure from trading partners, the threat is not so much that reforms will be directly reversed, but that their effects will be whittled away, little by little.

One alarming trend is the growing tendency of developing countries (Brazil, Chile, Korea, Mexico, and more recently India and Poland) to adopt and use the same kind of antidumping (AD) and countervailing duty (CVD) mechanisms that they have criticized the OECD countries for using against them. A few other countries (Colombia, Indonesia, Morocco, and the Central American Common Market) have also established such mechanisms, or are in the process of doing so. Altogether, developing countries reported 161 AD and CVD cases to the GATT from 1985 through 1992, with 96 of those between 1990 and 1992.

One clear challenge for trade policy in the 1990s and beyond is to limit the use of such mechanisms, or at least ensure that damage from them is minimized. Some institutions must be in place to respond to the inevitable pressures for exceptions, but they should be designed to safeguard, not undermine, the openness of the trade regime. Without such safeguards, the lesson from the OECD countries is that they will be captured by protectionist special interests. One way to support this goal is to design the mechanisms to ensure that the costs of proposed protective measures are aired publicly, as well as taken into account administratively and politically. Import consumers and industrial users should have the same legal standing as producers who claim they are injured by imports. A lesson from the problems of existing AD mechanisms is that the procedures used should not judge the existence or extent of injury against set criteria. Clever lawyers are adept at packaging the evidence in each case to pass the test. In an adversarial procedure pitting the gainers from protection against the losers, the deck is not so stacked in favor of the former.

Emerging issues

Even as old issues are being addressed, new themes, as well as new variants on old themes, are emerging that affect future trading relations among countries. The challenge of trade policy, therefore, is to ensure that such developments contribute to the momentum toward a more liberal trading system.

Regional trading agreements. Despite the undeniably poor record of regional integration arrangements among developing countries in the past, efforts to promote new agreements or renew old ones continue (see "East Asia: A New Trading Block?" in *Finance & Development*, March 1994). And NAFTA is apparently the beginning of a move toward more such arrangements between developing and industrial countries, at least in the Western Hemisphere.

It is far from clear whether this "new regionalism" differs sufficiently from the old to make it a positive development or not. On the one hand, many of the old problems are still present in some arrangements, though perhaps not as severe. These include the lack of complementarity in the productive structures of regional partners, the absence of convertible currencies and viable clearing arrangements for regional currency flows, and the continuing pressure to use integration as a way to increase protection for inefficient producers.

"Political imperatives to forge a regional identity could be most profitably channelled into cooperation in areas where unilateral action makes little sense...."

On the other hand, much of the new regional integration is being carried out among countries that are simultaneously lowering extra-regional trade barriers, thereby reducing the potential for trade-diverting effects. The new arrangements tend not to take the sectoral approach of the past, which resulted in attempts to administratively manage trade and investment. Rather, they cover "substantially all trade," as GATT requires. They also go beyond merchandise trade to liberalize factor flows and trade in services, and to harmonize regulatory regimes. Also, the North-South arrangements seem likely to include countries with complementary production and convertible currencies. These characteristics seem to indicate that the new regional integration may indeed complement the overall trade reform.

On balance, it is doubtful that these trade arrangements will have major effects, either positive or negative unless they develop into mutually antagonistic trading blocs. Contrary to common rhetoric, most serious scholars do not expect that even NAFTA will create large economic gains or losses. Even more so for groups of developing countries, regional integration through trade policy is an economic sideshow; the main event is integrating with the rest of the world. Political imperatives to forge a regional identity could be most profitably channelled into cooperation in areas where unilateral action makes little sense, such as certain infrastructure, education, or environmental projects. In addition, regional initiatives to lower barriers to factor flows are likely to be beneficial, so long as they do not divert attention from the much more important issue of removing barriers to extra-regional foreign investment.

The multilateral context. Greater engagement in the world economy by many developing countries during the last 15 years has led to fuller participation in multilateral trade negotiations. In the Uruguay Round, dozens of developing countries assumed additional international obligations with respect to a whole range of trade policy rules. These commitments will need to be built upon as governments extend the drive toward more open, competitive economies.

Apart from pushing liberalization forward in traditional areas and in agriculture and textiles, the Uruguay Round opened up new fronts in the fields of trade in services, trade-related investment measures, and intellectual property rights. This expansion of the negotiating agenda is partly explained by increased "globalization" of the international economy, which in turn is a product of many factors, among them government deregulation and rapid technological advance. The phenomenon of globalization is nowhere more apparent than in the growth of international financial markets and foreign investment flows. In the late 1980s, for example, world foreign exchange transactions amounted to about $600 billion per day, increasing to some $1 trillion by 1993. Moreover, foreign direct investment growth has far exceeded international trade growth since the mid-1980s.

Trade in services cannot be viewed in quite the same way as trade in goods, mainly because the output in many services sectors cannot be transported, requiring closer physical proximity between consumers and producers. As measured in the balance-of-payments current account, services represent about one third of trade transactions, and more if the value of services embodied in goods (transport, advertising, marketing, and so on) were taken into account. And the services sector is expanding at least as fast as most other economic sectors.

All participants in the Uruguay Round assumed new obligations in services trade, although these remain modest for the most

part. Given the importance of producer services (such as banking, finance, insurance, and transport) for overall competitiveness, and the gains to consumers from low-priced services, there are strong reasons for promoting further liberalization.

Trade related investment measures. Negotiations on investment issues in the Uruguay Round produced scant results, aimed only at restricting policies that linked investment rights to trade commitments (such as domestic content requirements). National investment regimes go much further than this in defining the rights and obligations of investors. As countries increasingly compete for investment funds, policies that determine the investment climate become crucial to future growth and development. Macroeconomic stability, policy consistency, and openness toward foreign investment are key components of progress. Governments are also likely to encounter competition policy as an element in future trade negotiations. In particular, there may be some interest in coordinating the use of domestic competition law to promote international competition, and perhaps one day, to transform antidumping from an instrument of protection into a remedy against anticompetitive behavior.

Trade related intellectual property rights. Finally, the Uruguay Round agreement established a series of standards for the protection of intellectual property rights, and provisions for their enforcement and for dispute settlement. The intellectual property rights covered include copyright, trademarks, and patents, and the commitments mean that many countries will have to adjust their intellectual property regimes. For those countries that do not generate much intellectual property themselves, these new arrangements could imply income losses. Such losses could, on the other hand, be offset by increased inward investment and research and development (R&D) of benefit to developing countries that would not have materialized in the absence of strengthened intellectual property protection.

New threats to the trading system. In addition to strengthening trade rules in some (but not all) areas, the Uruguay Round promises some definite improvements in market access. Tariffs will fall by more than one third. For nontariff barriers, the picture is more dramatic. The share of developing country non-oil exports to OECD markets covered by nontariff barriers will fall from just over 18 percent to less than 4 percent as a result of Uruguay Round commitments. The comparable figures for Eastern Europe are 20 percent and less than 5 percent.

These measures clearly support the trade liberalization efforts of developing and transition economies discussed earlier. But they could be undermined if governments resort to more frequent use of antidumping measures, given the limited success of the Uruguay Round in reforming the antidumping rules. Moreover, at least two emerging issues could pose new obstacles to market access: links between trade and the environment and workers' rights.

Trade and the environment. The view of some environmentalists is that trade itself may be intrinsically damaging to the environment, and that trade restrictions or the threat of them offer a useful mechanism for persuading other governments to modify their environmental policies. There are doubtless circumstances in which trade can exacerbate environmental problems by encouraging the production of goods under conditions in which negative environmental externalities are ignored. But the focus of attention here should be on how to address the externalities directly, and not on trade restrictions.

An immediate problem in linking trade and environmental issues is how the dimensions of environmental externalities are to be determined, and by whom. The charge of "eco-imperialism" responds to circumstances where powerful countries decide that particular environmental standards are appropriate for the world at large and then unilaterally adopt enforcement measures. Such an approach could be costly to developing countries, particularly if the objective is harmonization of environmental policies internationally, including production and process methods, regardless of differing ambient absorptive capacities and social priorities. International cooperation on these issues will be far less damaging to developing countries than unilaterally imposed coercive measures.

Workers' rights. The workers' rights issue is old, but has taken on a new lease of life in recent months. The case for using trade restrictions to punish perceived offenders of workers' rights feeds off a potent combination of moral arguments—one about fundamental human rights, and the other about "fairness." The case for trade restrictions against a country on grounds of human rights abuses is political, and while such arguments could be used in the same way as arguments about unfair competition to cloak a protectionist intent, trade policy discussions are unlikely to add much to the debate.

The more narrowly focused complaint that low wages are conferring an illegitimate advantage on producers in a particular country should, however, be addressed in economic terms. Often, the basis of the complaint is that wages (broadly defined to include the total cost of hiring a worker) are too low, making "legitimate" competition impossible. The notion that wages should be more equal across countries ignores vital considerations relating to domestic price structures and labor productivity. While economic theory predicts that trade will naturally produce a convergence of factor prices over time, proponents of forced wage equalization forget that if wages are driven up independently of increased productivity, increased unemployment is the likely result—surely an unwelcome outcome from the perspective of worker welfare. Many developing country governments would argue that relative wages are not a legitimate topic of discussion in a trade forum, and that broader issues relating to working conditions are already subject to international commitment under the auspices of the International Labor Organization.

Regardless of the dubious merits of arguments for trade restrictions in pursuit of environmental goals or the welfare of workers, pressures for trade restrictions on these grounds are likely to increase, and will be exacerbated by the susceptibility of such arguments to protectionist capture. It is worth recalling in this context that the use of political and economic leverage to force other countries to raise their production costs is no less damaging to consumers of the country pursuing this objective than direct trade restrictions on foreign goods. While developing and transitional economies may find it harder and less rewarding to pursue their programs of continuing trade liberalization, it should be remembered that the protectionism of others has never provided a sound argument for one's own protectionism. ■

Suggestions for further reading

For elaboration of some of the information presented here in summary form, see: "The New Regionalism and Its Consequences," by Carlos A. Braga, World Bank Discussion Paper, forthcoming; "Should Developing Countries Introduce Antidumping? Never," by Michael Finger, CEC *Outreach #1*, May 1992; "Nontariff Measures and Developing Countries: Has the Uruguay Round Leveled the Playing Field?" by Patrick Low and Alexander Yeats, World Bank Working Paper, forthcoming; "Implementation of Trade Policy Reform in Sub-Saharan Africa: How Much Heat and How Much Light?" by John Nash, Policy Research Working Paper No. 1218, November 1993; *Best Practices in Trade Policy Reform*, by Vinod Thomas, John Nash, and Associates, Oxford University Press for the World Bank, 1991.

Can Developing Countries Keep Foreign Capital Flowing In?

STIJN CLAESSENS AND SUDARSHAN GOOPTU

PRIVATE portfolio flows to developing countries have increased dramatically over the past five years and constitute a potentially large source of financing for the future development needs of these countries. But there are worries about whether flows could prove ephemeral, whether funds are being channeled to productive investment, and whether financing terms are appropriate.

Private capital flows to developing countries have tripled since 1990, to over $113 billion in 1993, their highest level since the debt crisis of the early 1980s. About half of these flows are accounted for by private portfolio investment (through bonds and equities), which reached an estimated $55.8 billion in 1993. The other half is accounted for by foreign direct investment (FDI), which has been driven by the intensified pursuit of worldwide production, sourcing, and marketing strategies by multinational corporations. FDI flows have also increased in response to the market potential offered by rising developing country incomes, liberalization in trade and investment regimes in these countries, and the telecommunications technology revolution.

As for private portfolio flows, investors have been highly selective since 1989; more than half the flows have gone to Latin America, and five countries (Argentina, Brazil, Korea, Mexico, and Turkey) accounted for two thirds of the flows.

This dramatic increase reflects a number of developments. These include better economic "fundamentals" and growth prospects, large-scale privatization of enterprises in certain countries, opening up of equity markets to foreigners, favorable interest and equity return differentials with industrial countries, increased globalization of capital markets, and a structural shift to the private sector of the burden of generating economic growth.

The composition of capital flows to developing countries has changed over the past 20 years. In the 1970s, external financing to developing countries was channeled primarily from foreign commercial banks to governments. By the early 1980s, many countries were facing large external debts and tight external financing constraints, which led eventually to severe debt-servicing difficulties. Private lending to developing country governments not only dried up, and potential investors remained wary of lending to private borrowers in those countries. In contrast, with the recent improvement in the macroeconomic situation and the investment and regulatory climate in many developing countries, most of the financing flows in the 1990s have been extended by private lenders to private borrowers, and the source of this financing has largely shifted from banks to nonbanks through increased portfolio and direct foreign investment.

These developments hold out the promise of increased investment and growth for the recipient countries but, at the same time, raise a number of important questions: Can portfolio flows contribute in a substantive, sustained way to the financing needs of developing countries? Are the maturities and cost of funds well suited to long-term development, and are the funds being channeled to productive uses? Are new kinds of financial instruments desirable and likely to be developed? Could portfolio flows destabilize economies, and, if so, can destabilization be averted? How can the enthusiasm of industrial country

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investors, which is now aimed at a number of emerging markets, [illegible] wider range of developing [illegible]

How big are the flo[illegible]

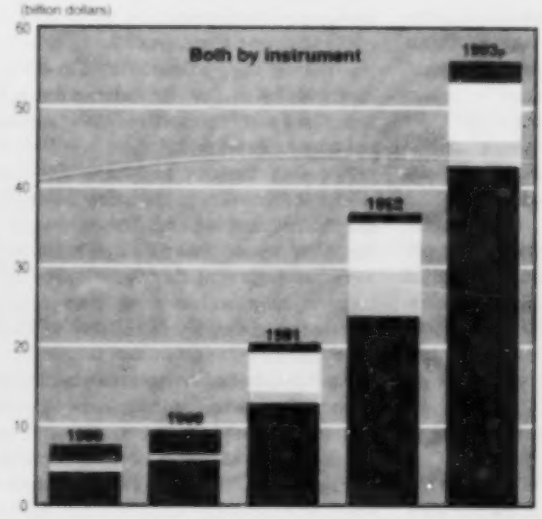
At the beginning of the 1980s, private international capital flows were at an all-time high. Gross portfolio flows increased from about $7.5 billion in 1989 to about $55.8 billion in 1993, primarily in the form of debt instruments (bonds, certificates of deposit, and commercial paper), which rose from $4 billion in 1989 to $42.6 billion in 1993 (see charts). Although some of this represented the return to the Euro-bond markets of public sector borrowers (e.g., Czech Republic, Hungary, and Turkey), the bulk of the funds were private-to-private flows.

Investment in equities also rose, more than tripling during 1989–93 to $13.2 billion, mainly in connection with large-scale privati[illegible] programs carried out in a few Latin American countries. This growth also reflected a sizable increase in flows to the East Asia and Pacific region, explained in part by the opening up of the equity markets in these areas to foreigners. For example, in China, firms started to list stocks on the Hong Kong exchange, and Korea has relaxed restrictions on foreign ownership.

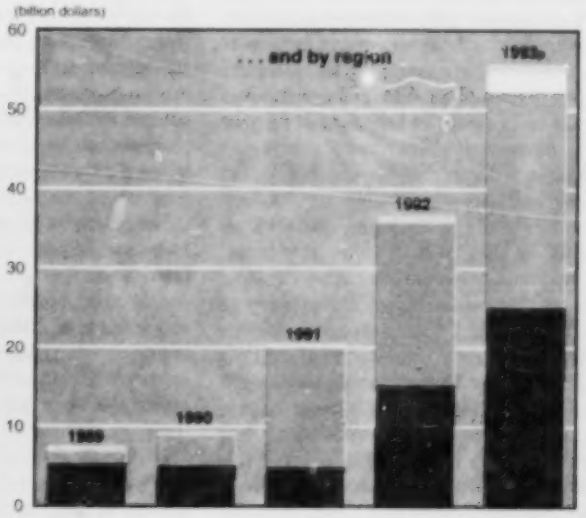
Inflows and privatization

Foreign investors have participated in large privatization programs, especially in Latin America, through equity portfolio investment. In July 1990, Chile was the first developing country to use American Depository Receipts (ADRs) ($98 million issued in the New York Stock Exchange) for the sale of Teléfonos de Chile. In 1991, Argentina issued $364 million in Global Depository Receipts (GDRs) for the privatization of Telefonica de Argentina (see box). To date, the largest international equity issue by a developing country in conjunction with a privatization program was a $3 billion

Portfolio flows to developing countries have increased dramatically



	1989	1990	1991	1992	1993p
Bonds, CPs & CDs	4.0	5.5	12.7	23.7	42.6
Direct equity investment	1.3	0.8	1.5	5.8	3.2
Depository receipts	0.0	0.1	4.9	5.9	7.3
Country funds	2.2	2.9	1.2	1.3	2.7
Total	**7.5**	**9.3**	**20.3**	**36.7**	**55.8**



	1989	1990	1991	1992	1993p
East Asia & Pacific	2.88	3.14	4.04	10.00	15.92
Europe & Central Asia	2.3	1.91	0.80	5.17	9.22
Latin America & the Caribbean	1.39	3.77	14.96	20.47	27.20
Global investment funds	0.08	0.04	0.25	0.14	2.64
Other regions	0.86	0.47	0.22	0.93	0.82
All developing countries	**7.52**	**9.33**	**20.27**	**36.71**	**55.79**

P = Projected.
Source: World Bank, *World Debt Tables, 1993–94*.

ADR issue by the Argentine state oil company, in June 1993.

There is also evidence that foreigners have made direct purchases of equity in newly privatized enterprises. According to the World Bank, 21 direct equity purchases were recorded during 1988–92 for a cumulative total of $4 billion, or 8.5 percent of total privatization revenues for developing countries and almost 28 percent of total foreign exchange inflows resulting from privatization transactions. Equity portfolio investment has thus proved to be attractive for directly mobilizing foreign financing for large-scale privatizations as well as indirectly through follow-up equity issues by recently privatized enterprises.

A break with the past?

There are reasons to believe, at least for those developing countries with more sophisticated capital markets and a strong track record of economic reform, that foreign portfolio flows may become a reliable source of private sector financing over the coming years.

Diversifying sources and instruments. The sources of flows to developing countries (initially associated with the return of flight capital) have greatly expanded in the last few years. The flows now come from a variety of investors: managed funds, institutional investors (e.g., pension funds and life insurance companies), performance-oriented securities traders, and the nonresident citizens of the countries concerned. This diversity lessens the risk of a sudden and simultaneous drying up of flows, as happened in the past with commercial bank loans. Borrowing instruments have also become both more diverse and more sophisticated, implying that the future needs of developing country markets will be adequately served because financing instruments can be more closely tailored to borrowers' needs. Foreign investors may be able to provide financing instruments that are unavailable in developing countries' domestic capital markets. Many financial instruments can also be "synthesized" from existing instruments, which include equities, ADRs, country funds (a type of investment fund specializing in portfolio investment in one or more countries), convertible bonds, warrants, commercial paper, certificates of deposit, bonds with put and call options, floating-rate notes, and local currency instruments.

Greater risk bearing. Risk bearing by investors has increased since the 1970s, especially through investment in stocks. Unlike traditional commercial bank lending, investment in equities has the advantage of effectively matching "debt-service payments," or dividends, with ability to pay. Furthermore, foreign investors will have an incentive to monitor the investment because they will have a real stake in the fortunes of the company as well as in the country concerned. Large equity investment may also benefit the recipient country by introducing technology transfer, management know-how, and access to export markets, all of which will improve the long-term sustainability of private capital flows.

Other benefits. As emerging markets integrate with the global economy, the cost of capital is expected to decline. For example, the increased use by Argentine entities of international capital markets has been associated with lower interest rate spreads for these borrowers. Today's portfolio flows are expected to generate efficiency gains. In contrast with the 1970s, most of the portfolio flows now go to private borrowers who are subject to market discipline. Thus, funds are more likely to be channeled to those who are best placed to increase growth-generating, productive investment.

"Although concerns about unstable portfolio flows have not been dispelled, some observers argue that they are overstated."

Beyond these direct gains, there are the long-term benefits of increased market-oriented flows. A well-functioning stock market should result in better resource mobilization and allocation. Indeed, country funds can improve pricing efficiency in local capital markets and help local firms mobilize domestic capital at lower costs.

But there are risks

Private-to-private flows do entail some risk because of their nature and the sheer magnitude of the flows. In addition, the maturities may be inappropriate for long-term project financing and the flows do not appear to be reaching "second-tier" borrowers, who may not have good access to domestic financing sources either.

Sustainability. Increased financial integration brings both opportunities for higher investment and growth and challenges of macroeconomic management. Because the flows are a relatively recent phenomenon, there are concerns that they could be reversed easily. (See "Surges in Capital Inflows: Boon or Curse?," by Susan Schadler, *Finance & Development*, March 1994.) Whether these portfolio flows will continue in the long run depends crucially on (1) whether a stable macroeconomic environment is maintained; (2) how they are being used—for consumption (less sustainable) or domestic investment (more sustainable); (3) whether they lead to rapid export growth so as to improve future repayment capacity; and (4) whether a stable, investor-friendly economic and political environment is maintained over the long term.

Although concerns about unstable portfolio flows have not been dispelled, some observers argue that they are overstated. For example, empirical evidence shows that, although US transactions in emerging market equities are more volatile than those in other foreign equities, the volatility has been declining. Volatility of domestic stock prices has also been shown to decrease soon after market opening as more information becomes available to outside investors. Concerns about the instability of short-term flows may be similarly unwarranted. Many analysts feel that volatility associated with a particular type of capital inflow is more likely to be generated by changes in the institutional structure of a country's financial markets than by the characteristics of any particular flow. This view is supported by studies that indicate that long-term flows are often as unpredictable as short-term flows (see reference).

Nor does the fact that these flows are mostly short term imply that they do not benefit the recipient country. The experience of the 1970s shows that although most flows were then long term, they did not benefit the country. Today, because these flows go to the private sector, they are more likely to benefit the country.

Suitability of instruments. Interest rates on foreign borrowing may be attractive (partly as a result of low international interest rates), but the maturities of most bonds and money market instruments are too short to match the financing needs of many developing country projects. Although the average maturity of new bond issues by developing countries rose from about three years to five years in 1989–92, it remains much shorter than the long-term horizon of most development projects. Greater involvement of institutional investors with longer investment horizons may, over time, alleviate this mismatch.

Lending too concentrated. Private portfolio flows have mainly been directed to a few middle-income countries in East Asia and Latin America, China, and, more recently, India. In 1993, over 80 percent of the portfolio flows through bonds to Latin America were directed to Argentina, Brazil, and Mexico (accounting for about 40 percent of the total to developing countries). In the same year, over 80 percent of bond flows to Asia went to China, Korea, and Thailand. Equity flows were similarly concentrated in 1993, with 75 percent of those going to Latin America directed to Argentina and Mexico alone and 85 percent of those to Asia directed to China and Korea alone.

A portion of these portfolio flows, representing a vote of confidence from investors, is going to those countries that have registered sustained progress since the debt crisis of the 1980s (with improved macroeconomic management, large privatization programs, price liberalization, and institutional reforms in the domestic capital markets). These efforts have contributed to economic stability and are expected to yield high economic growth rates, and, in turn, high returns to investors in the long run.

Portfolio flows are also going to countries in which investors expect to make high short-term returns as they seek to take advantage of temporary profit opportunities that may arise from inconsistent macroeconomic policies. In these countries, interest rates are high as a result of the tensions created by a tight monetary policy pursued in conjunction with loose fiscal policy and doubts about the credibility of government policies. Portfolio flows that are motivated by "good" economic fundamentals in an environment characterized by consistent macroeconomic policies should be more sustainable than those motivated by inappropriate policies and a lack of progress in structural reforms.

What countries can do

To continue to attract portfolio flows, developing countries need to provide a favorable macroeconomic and regulatory climate for investors. At the macroeconomic level, this means pursuing sound financial policies and correcting structural problems, such as excessive government intervention, labor market distortions, and inefficient tax and trade policies. Sound domestic policies are also important to mitigate the appreciation of the real exchange rate that often accompanies large capital inflows.

At the sectoral level, governments need to establish an appropriate institutional framework to channel the increased flows. The choice of intermediary—the banking system or the stock market—is pivotal because the intermediary affects the final uses of the funds and the possible negative effects on the economy when funds are withdrawn. In addition, many countries need to improve prudential and supervisory functions as well as government regulation of the financial sector. Others, particularly in Eastern Europe, may have to create financial structures from scratch. In general, countries can benefit from the portfolio inflows only if they have a healthy and properly regulated banking system.

As countries get the macroeconomic fundamentals right, the amount of portfolio flows and consequent benefit—a lower cost of capital—will increasingly depend on whether they have their microeconomic fundamentals right too: few regulatory barriers, proper taxation, and ease of access by foreign investors.

Foremost, they need to continue lowering barriers to portfolio investment—legal hurdles, poor credit ratings, high and variable inflation, limits on the size of emerging stock markets, the absence of a solid regulatory and accounting framework and investor protection, inadequate clearing and settlement procedures, lack of modern communications, and too few country funds or internationally listed securities. Empirical evidence shows that these barriers raise the risk-adjusted cost of capital. Some barriers—for example, poor credit ratings—obviously cannot be removed overnight. In addition, portfolio flows to developing countries depend not only on domestic regulations but also on industrial country regulations. Thus, developing countries can benefit only if industrial countries relax some of the uneconomic and severe restrictions on the composition of assets that pension funds and other institutional investors can hold abroad.

Some domestic barriers can be removed fairly easily, and developing countries should concentrate on these. They can, for example, harmonize the taxation of capital gains and dividends with that in industrial countries. Empirical evidence indicates that taxes that are not thus harmonized raise the risk-adjusted cost of capital in developing countries. Developing countries can also adopt investor safeguards relatively easily, especially if they rely on regulations adopted and enforced by market participants.

The action that would bring the most immediate results would be to reduce restrictions on access by foreigners (e.g., ownership restrictions, remittance restrictions, other foreign exchange restrictions, and restrictions on capital structure) so as to lower the cost of capital in these markets. Many developing countries have initially allowed only restricted access, for example, by limiting foreign ownership. Such access barriers are an important component of overall barriers and have a negative effect on stock performance.

To date, foreigners have been allowed to purchase stocks irrespective of risk properties. However, allowing them to buy "blue-chip" firms (firms that are already transnationals) does not significantly decrease the cost of capital for the firm itself and has few positive spillover effects on the rest of the market. In contrast, in the case of stocks of small and medium-size firms, foreign investment can lead to a sharing of some of the risk and can lower the risk-adjusted cost of capital for these firms.

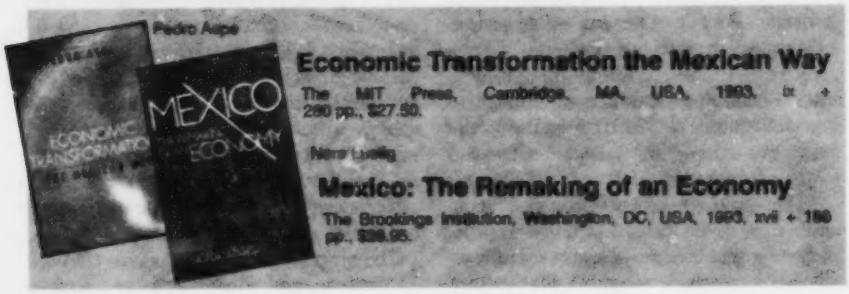
The prospects for continued, substantial portfolio flows to developing countries are favorable. Emerging markets generally offer good economic performance and, because they are still underweighted in the portfolios of industrial country investors, they are likely to continue to attract investors for some time to come.

It must be recognized, however, that some of these private flows can be volatile, that their volume to some countries is unlikely to be maintained at prevailing levels, and that they can place upward pressure on exchange rates and thus erode export competitiveness. There is also a risk of a reversal of these inflows if investment conditions in industrial countries become more favorable. Sustaining these private capital flows in the long term calls for maintaining a stable economy and an investor-friendly environment where developing country exports continue to grow rapidly. ■

American Depository Receipts *(ADRs) are equity-based financial securities that are denominated in US dollars. They are publicly traded in the US securities exchanges (NYSE, AMEX, NASDAQ) and are backed by a trust containing shares of non-US corporations.* Global Depository Receipts *(GDRs) are similar to ADRs except that they are offered in the US private placement market (under SEC Rule 144A) as well as in stock markets other than in the United States. GDRs can be traded in several currencies.*

This article draws on papers presented at a conference held in Washington in September 1993. The proceedings are provided in Portfolio Investment in Developing Countries, *by Stijn Claessens, Michael Dooley, and Andrew Warner, in Claessens and Gooptu (editors) World Bank Discussion Paper No. 228, December 1993, available from the World Bank.*

BOOKS


Pedro Aspe
MEXICO
Economic Transformation the Mexican Way
The MIT Press, Cambridge, MA, USA, 1993, ix + 260 pp., $27.50.
Nora Lustig
Mexico: The Remaking of an Economy
The Brookings Institution, Washington, DC, USA, 1993, xvii + 186 pp., $39.95.

A great deal has been written about the Mexican stabilization and reform efforts of the 1980s and early 1990s. One of the most comprehensive and certainly the most authoritative accounts is *Economic Transformation the Mexican Way*, the writer having had a front seat for several years, serving in various capacities in the Mexican Government, including as Minister of Planning and Budget and currently as Minister of Finance and Public Credit.

This book, which is a compilation of lectures given in 1992 under the Lionel Robbins Lecture series, provides an overview of the stabilization and structural reform program undertaken over the period 1983–91. Its central theme is that the significant demand adjustment in 1983–87 left the economy in severe recession with persistently high inflation mainly because of structural imbalances in the real sector and inflation inertia. According to Aspe, stabilization and growth were achieved only after the adoption of a new strategy centered around a social pact (involving labor, farming, and the business sectors) that forged a consensus on a path for incomes, key prices, and the exchange rate. In return, the Government committed itself to achieving a permanent solution to fiscal imbalance, accelerating structural reforms, and negotiating a comprehensive external debt rescheduling agreement.

Aspe provides interesting insights as to the mechanisms employed to build mutual confidence among the participants and credits the pact with facilitating the sharp deceleration in inflation (from 159 percent at the end of 1987 to around 20 percent in 1991) and the economic recovery that began in 1989. His discussion of the structural reforms also serves as useful advice to policymakers on operational issues and sequencing. For example, he emphasizes that once-for-all revenues from privatization must not be used to finance recurrent spending; that external debt rescheduling needs to be comprehensive enough to be perceived by economic agents as a lasting solution; and that trade liberalization is likely to be more successful if it begins with an exchange rate that bolsters competitiveness.

The author identifies a number of important challenges that lie ahead for Mexico, including the need to increase the rates of domestic savings and investment (in human as well as physical capital), the need to raise productivity so as to remain competitive and, importantly, the need to make sure poverty is eradicated. Aspe notes that overcoming these challenges will require continued adherence to sound economic policies.

Since 1992, when the research for the book was completed, the process of economic modernization in Mexico has continued apace. The North American Free Trade Agreement has been approved, foreign investment regulations have been liberalized further, and the Bank of Mexico has been granted operational and administrative autonomy. It has not been smooth sailing all the way, however. Economic growth has stalled since mid-1993, in part reflecting the effort to bring down inflation and the ongoing restructuring of the manufacturing sector, while social and political uncertainties resulted in occasional pressure on financial markets in the first half of 1994.

Aspe explains that his main reason for writing the book was to provide a straightforward description of the way in which Mexico had been going through the transition. He accomplishes his objective with a comprehensive and generally readable account. As Aspe was one of the architects of the social sector strategy initiated in the mid-1980s (under which there was a substantial increase in social spending in real terms), it is to be hoped that he will complement what he has presented so far with a discussion of the requirements for successful social policies.

Nora Lustig's less technical and faster-paced book, *Mexico: The Remaking of an Economy*, covers much of the same ground as Aspe's, but as an outsider (she was a Professor of Economics at Mexico City's prestigious Colegio de Mexico before becoming Senior Fellow at the Brookings Institution in Washington, DC) she takes a more questioning approach, focusing on the social costs of the adjustment program.

Lustig attributes the economy's stagnation and persistent inflation during 1982–88 to the large negative resource transfers (mainly due to the onerous debt-service burden and adverse external conditions) that discouraged private investment and to the frequent depreciation of the peso. However, she agrees with Aspe that the social pact combined with the intensified structural reforms (in particular, privatization and the prospect of the NAFTA) and external debt rescheduling, were crucial to the ultimate economic turnaround.

Lustig attempts a detailed accounting of the social costs of the adjustment in the earlier period, highlighting the sharp fall in real wages, increased income inequality between high and middle-income households, and large cuts in social programs. Although the data are not conclusive, she suggests that cuts in social sector spending were related to a decline in nutritional standards and health services and to increases in crime and the incidence of school dropouts. More recent data suggest that some of the social costs cited by Lustig were transitory. The proportion of households living in extreme poverty peaked in 1989 and fell to pre-crisis levels by 1992. The minimum wage, on which Lustig bases much of her discussion, has become much less important as an indicator of wage developments (covering only

about 16 percent of all workers compared to over 40 percent in the late 1980s), and negotiated wages have advanced strongly in real terms in the last four years. Further, debt reduction using the proceeds from privatization has permitted policymakers to increase sharply social expenditures in real terms since 1989.

Lustig raises several questions about the economic strategy pursued in the 1980s (among them, whether incomes policy came too late and trade liberalization too early) and wonders whether a less costly adjustment (in social terms) and an earlier recovery, would have been possible. She finally agrees with the Government's overall strategy but argues that the social costs could have been reduced and an earlier recovery achieved but for the delay in the provision of assistance by the international community. This contention is debatable. For while the existence of a resource restraint could always be blamed for slower than expected progress, the facts are that during 1982–88, Mexico received significant external support through debt rescheduling from commercial and bilateral creditors and new disbursements from multilateral agencies.

Like Aspe, Lustig also finishes on an optimistic note. She sees the large current account deficits that accompanied the recovery in 1990–91, as the result of a temporary surge in consumer and capital goods imports reflecting trade liberalization and the need to modernize productive capacity. In her view, with NAFTA and with continued macroeconomic stability, these deficits should be viewed as manageable.

Ewart Williams and John Thornton

John Williamson (editor)

The Political Economy of Policy Reform

Institute of International Economics, Washington, DC, USA, 1993, ix + 601 pp., $25.

This is a refreshingly different entry in the genre of recent political economy studies; it gets away from the earlier focus on developing countries and includes a few industrial countries among its 13 case studies (Australia, New Zealand, Portugal, and Spain) and one transition country (Poland) on the reasoning that "at least in intellectual terms, we today live in one world rather than three." It also breaks new ground in seeking as authors for analyzing the political process through which economic reforms work (or fail to work, as in Brazil and Peru among the countries examined), a slate of "technopols" or economists-turned-politicians who played a decisive role in crafting the economic content of the reforms and then implementing them, for most cases, in a politically successful manner.

Despite being a conference volume, this one avoids the discursiveness and lack of focus that characterizes most such collections of papers. The editor sets forth in advance, for his distinguished cast of authors to address, a series of hypotheses about the circumstances under which policy reform becomes possible and the ways in which reform can be promoted. In the final chapter, John Williamson and Stephan Haggard pull together the main conclusions regarding the economic and political conditions that are necessary for successful adjustment.

An initial distinction is drawn between democratically run countries and nondemocratic regimes. Some of the hypotheses are not relevant to the latter group of countries—e.g., the exploitation of a "honeymoon" period when difficult decisions can be blamed on an outgoing administration. What is important for "technopols" is that they exploit whatever opportunities come to hand, whether by way of an economic crisis or a political one (such as the example of the Qureshi caretaker administration in Pakistan). Similarly, an authoritarian regime need not seek social consensus, although some would go as far as to assert (with Jeffrey Sachs) that the latter condition is not essential anywhere. If reforms succeed, it is argued, a social consensus will emerge in support of them and if they fail, no amount of prior social consensus building will prevent their rejection. This proposition is belied by most of the successful cases, where political support has been essential to consolidate—and even initiate—reforms. The unfortunate experience in Venezuela is an example where radical policy changes were sprung on a public that saw no crisis justifying them.

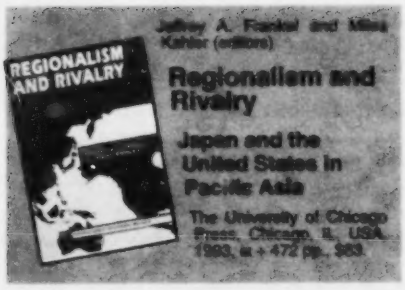
Among the hypotheses that are sustained in most of the successful cases is the requirement for strong "visionary" leadership. In addition, a necessary, though not sufficient, condition for success is a competent economic team invested with enough authority to withstand the pressures of interest groups and competing centers of bureaucratic power.

A hypothesis of great interest, especially to those working for the international financial institutions (IFIs), is the role of external agencies. The ability to secure conditional financial support greatly strengthens the hands of reformers in countries that either do not have access to markets or that have temporarily lost access in a crisis.

Of perhaps equal, or even greater importance than conditional financial assistance, was found to be the intellectual support that is offered, often in times of crisis, by outside agencies. Here the role of the IFIs as suppliers of technical assistance and training facilities is quite appropriately emphasized. What is missing in the analysis is the comparative advantage of IFIs, relative to bilateral lenders, in two respects: first, that conditionality is politically more palatable when applied through institutions to which the borrowing country itself belongs and on whose policy-making board of directors it is represented; second, the fact that in a number of instances, the "technopols" may have themselves worked in the IFIs and have personal connections that help in facilitating the negotiating process.

Three hypotheses for which sufficient data were not forthcoming relate to the use of media in "selling" reforms, the payment of compensation to "losers," and the deliberate acceleration of gains from reforms through rapid improvements in one or two critical areas, such as selected basic services like urban transport. Some of these issues have been explored in a developing country context by political scientists like Joan Nelson and her colleagues (see review by Charles Gardner iFinance & Development, June 1990) The fact that these issues were not fully addressed by the authors contributing to this volume should not be taken to gainsay their undoubted importance to a successful consummation of the reform process.

Aziz Ali Mohammed


Jeffrey A. Frankel and Miles Kahler (editors)
REGIONALISM AND RIVALRY
Regionalism and Rivalry
Japan and the United States in Pacific Asia
The University of Chicago Press, Chicago, IL, USA, 1993, xi + 472 pp., $83.

The policy community is sharply divided among those who believe that markets in East Asia, particularly Japan, are closed and those who argue the opposite. Over time, the view has gained ground that Japan is quietly building a trade and investment bloc around itself in East Asia. This conference volume, consisting of 11 papers, including a commentary on each paper, subjects this view to a systematic analysis and rejects it resoundingly. An important strength of the volume is that it brings together economists and political scientists and provides a broader analysis of the issue than normally done.

The volume is divided into three parts. Part I faces the issue head on: Is Pacific Asia becoming a regional bloc? The first paper, by Peter Petri, traces carefully the history of the evolution of intraregional interdependence in East Asia. Though the paper analytically falls far short of the author's aspirations, it establishes conclusively that the interdependence within East Asia in the post-Second-World-War era is far below its prewar level. Frankel takes a more quantitative approach and tests for the existence of an informal bloc in East Asia. He finds that once we control for the expansion of intraregional trade due to faster growth in the region, the hypothesis of either the existence of a bloc or a trend toward it is rejected conclusively. Frankel also fails to find evidence of a special Japanese effect on trade within East Asia. On the financial front, he finds some evidence of Japanese influence but concludes that it is less than the US influence. Gary Saxonhouse finds that, controlling for income levels, trade patterns of leading economies in the region are biased not in favor of itself but North America! Moreover, using a model of international price discrimination, he finds that Japanese firms are able to segregate markets in East Asia but not in North America. This evidence is doubly damning to the claims of highly integrated markets in East Asia.

Since the preceding papers have established that East Asian markets are not highly integrated with regard to trade, proponents of the view that Japan is quietly building an East Asian bloc are left arguing that it is establishing pernicious links via investment and aid. Part II analyzes the role of Japanese direct foreign investment in East Asia in promoting East Asian market integration. While topical, the papers in this section are unfortunately less rigorous in their economics.

Richard Doner argues that East Asia is becoming increasingly integrated in terms of production and diffusion of Japanese-style institutions. Many of these arrangements, however, are simply responses to prevailing economic conditions and not conscious attempts at establishing a regional bloc. Peter Katzenstein and Martin Rouse use case studies of Thailand and Indonesia to demonstrate how Japan is exercising its role as a regional power in East Asia. While drawing conclusions about regional arrangements from particular country case studies is questionable, drawing unwarranted ones is doubly so. That Japan has been the most significant source of foreign investment in these countries hardly leads to the conclusion that it has been acting as a regional economic hegemon. Particularly puzzling is their suspicious view of Japanese aid in the development of infrastructure. Given their public good and nonexclusive nature, investments in infrastructure benefit Japanese and non-Japanese alike.

Part III covers a variety of themes. Topics in this section range from coprosperity spheres and money and finance to security aspects of US-Japan economic relations. Of particular interest is the paper by Shafik Islam on foreign aid and burden-sharing that addresses whether Japan is an international "free-rider." The author reviews the pattern of Japanese aid and trade and finds little evidence that Japan systematically biases its aid to promote its trade and investment interests. The paper by Martin Feldstein contains an interesting discussion about whether Japan wants to establish a hegemonic position in the future. He concludes that the costs of doing so—in terms of conflict with the United States—significantly outweigh any potential benefits. Given its large investment and trade interests in the United States, Japan is acutely aware of its vulnerability to changes in US tax and trade policy.

The book is not the last word on the subject. But the authors have undoubtedly helped place the debate on a higher analytical level and, in the process, scored one victory against Japan bashers.

Arvind Panagariya and
Sethaput Suthiwart-Narueput

Soedjatmoko was very much rooted in Indonesian culture yet deeply committed to internationalism. In his early life, he was active in Indonesia's independence movement and later became his country's Ambassador to the United States. Yet, never fully at ease in the political climate of his own country, he often found a more receptive audience overseas, ending his distinguished career as Rector of the United Nations University in Tokyo.

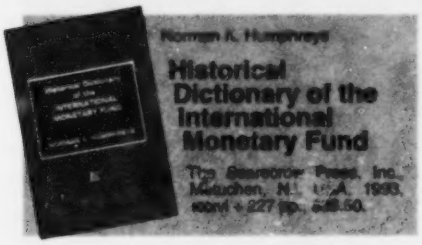
Although his formal education was limited, Soedjatmoko was well read in the works of both Western and Eastern scholars and moved comfortably in intellectual circles. But the strength of his ideas comes more from his own personal concern and commitment to development, including the dimensions of development that are too often neglected such as, freedom, democracy, human rights, and tolerance. In this book, the editors have done an excellent job of compiling 18 papers, written between 1970 and 1987, capturing both the breadth and evolution of Soedjatmoko's thoughts. The limited introductions accompanying each chapter provide sufficient context and continuity, without distracting from the primary force of Soedjatmoko's own work.

Two broad themes run through all of these papers. The first is Soedjatmoko's personal philosophy of "responsiveness, resilience, restraint, and open-mindedness." He has a healthy distrust of ideology, experts, and simple solutions. The second is his very broad view of development as "a process of social change, a process of transformation of the soul, and the creative adaption of culture." Soedjatmoko's writings are not easily characterized in terms of conventional disciplines and subject matter. Rather they stand out for the clarity with which they present an eclectic view of a complex world.

Soedjatmoko's vision captured many aspects of development, and their interrelationship, well before they became part of the accepted paradigm. Reading these papers today, one is struck by the attention given to issues such as popular participation and governance, the power of new information technologies, and management of the natural environment. Above all, Soedjatmoko stresses that development is learning. Education provides the basis for participation and tolerance. Yet Soedjatmoko was also frustrated by the inability of intellectuals to marshall their own skills—social science, humanities and technology—to solve development problems.

These writings leave me with two regrets. The first is that Soedjatmoko himself was often not able to bridge the gap between intellectual conviction and political reality. As a result, his vision is at times unduly pessimistic, focusing on what is left to be done and undervaluing the very real economic and social progress that has been made in many parts of the developing world. Finally, echoing a thought by Clifford Geertz, I too regret that Soedjatmoko did not have time to compile his own thoughts before his death. The result may well have been new insights into the challenges now facing the world in the 1990s.

Mark Baird



"A writer of dictionaries, a harmless drudge": thus did Samuel Johnson, himself the author of the monumental *Dictionary of the English Language*, define the labor-intensive burden of a lexicographer. No one, however, would dispute the value of the finished product. In his *Historical Dictionary of the International Monetary Fund*, Norman Humphreys, Chief Editor at the IMF from 1972 until 1986, has likewise performed a valuable service. Humphreys has pulled together a wide-ranging and disparate collection of facts about the IMF, together with succinct, jargon-free definitions of the IMF's operations, its instruments, its structure, and its idiosyncratic spin on economic concepts—all within a clearly defined (and helpfully cross-referenced) historical perspective.

For instance, under *devaluation*, Humphreys covers the Bretton Woods system of fixed exchange rates, the failure of the Bretton Woods system, the second amendment of the IMF's Articles of Agreement, and the effect that the arrangements that replaced the Bretton Woods system had on the ability of countries to adjust their exchange rates.

The *Dictionary* also includes brief descriptions of IMF departments; short biographies of principal players and personalities; histories of the IMF's relations with the World Bank and the United Nations; a statistical appendix; and a bibliography listing publications on the history and evolution of the IMF, as well as most of the IMF's own publications.

The dictionary entries are preceded by a chronology, which runs from July 1, 1943 through June 30, 1993; and an introduction, which provides a historical overview and discussions of the evolution of important IMF concepts and operations, such as *conditionality* and *surveillance over exchange rate policies*.

Humphreys' *Historical Dictionary* neatly encapsulates a half-century of international economic developments. The appearance of this immensely useful reference work on the eve of the 50th anniversary of the Bretton Woods Institutions is perfectly timed.

Sara Kane

BOOKS *in brief*

Michael M. Cernea and Scott E. Guggenheim

Anthropological Approaches to Resettlement

Policy, Practice, and Theory

Westview Press, Boulder, CO, USA, 1993. xii + 406 pp., $45

Throughout history, there has always been displacement and resettlement, but the 1980s might well be remembered as the "decade of displacement" because of the large numbers of people evicted from their houses, farms, and communities and forced to find a living elsewhere. Some of this displacement stems from famines, wars, and homelessness. But another key cause is the escalating number of large development projects (see "Population Resettlement and Development" in this issue). Growing concerns surround the adverse environmental and social impacts, increasingly well-organized resistance to resettlement in many parts of the world, and the need to reconcile improving physical infrastructure with protecting the rights and interests of those most immediately affected by displacement.

In this volume, the editors—Mr. Cernea is the World Bank's Senior Adviser for Social Policy and Sociology, and Mr. Guggenheim is an Anthropologist with the Bank—provide the most comprehensive worldwide summary available on different approaches to resettlement. The contributors, representing nine countries, have been deeply engaged in the practical dimensions of resettlement, as social scientists, advocates, planners, and analysts. A general theme, as summed up by the editors, is that resettlement will succeed only when the "traditional tools of development planning are complemented by ethnographic research and the active involvement of the people affected by resettlement in project decision making."

Anjali Kumar

State Holding Companies and Public Enterprises in Transition

St. Martin's Press, New York, NY, USA, 1993, xvii + 296 pp., $47.50.

Ms. Kumar's review and synthesis of international experience with state holding companies comes at an opportune moment as many economies are in transition from dominant state ownership of enterprises to market economies dominated by the private sector. Although privatization is usually the solution advocated, not all countries are able to implement this strategy quickly. To improve public enterprise performance in the meantime, these countries are experimenting with transitional organization structures, such as state holding companies and asset management companies that attempt to separate the government's ownership function from enterprise management to enhance enterprise efficiency. This book provides a valuable framework for comparing state holding and asset management companies of developed and developing countries and transition economies including Algeria, Egypt, Germany, Italy, and several East European countries. The author concludes that these structures are flexible organization forms that can achieve some clearly stated objectives, but remain vulnerable to government intervention and bureaucracy. If any weakness exists in this thorough, clear analysis, it is in omitting a discussion of the inherent inadequacy of state ownership in the allocation of residual risk and control. With state ownership, the residual risk is borne by the population as a whole. The state holding or asset management company, which exercises ownership rights on behalf of the population as a whole does not bear any residual risk. This book suggests that the flexibility of the state holding company structure, however, permits certain options to assign residual risk and control to improve enterprise governance and performance.

Richard E. Baldwin

Towards an Integrated Europe

Centre for Economic Policy Research, London, United Kingdom, 1994, xiii + 234 pp., $19.95.

The European Union (formerly European Community) has been evolving since its inception almost four decades ago: deepening as progressively more slices of economic and social life are brought within its ambit; and widening with the accession of new members. The process continues. Maastricht envisages further integration while the breakup of the Soviet hegemony in East Europe has brought new candidates knocking at the door. This volume, prepared for the European Commission, is a critique of the somewhat haphazard process being applied to the association of the new would-be members. Conceding that these countries are at least two decades from full membership, the author proposes replacing the current "hub-and-spoke" pattern of transitional association arrangements with a more rational, streamlined system of concentric circles, i.e., full integration by degrees (while multilateralizing trade preferences within each circle). This is a book for the Euroenthusiast, complete with short forays into integration theory, history, and mechanisms. It is well focused and convincingly argued.

Credits: Cover art and art on pages 2 and 7: Eric Westbrook. Art on pages 10, 50, 51, 62, and 63: Mark Robinson. Art on pages 14 and 46: Lew Armistead. Art on pages 29, 30, 34, 36, 38, 42, and 58: Luisa Watson. Art on page 56: Dale Glasgow. Photos on pages 27, 66, 68, 69, 70, 71, and 72: Padraic Hughes-Reid. Photos on pages 29, 30, 34, 36, 38, and 42: Secretary's Department, IMF.

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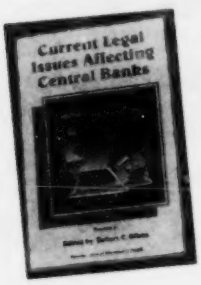

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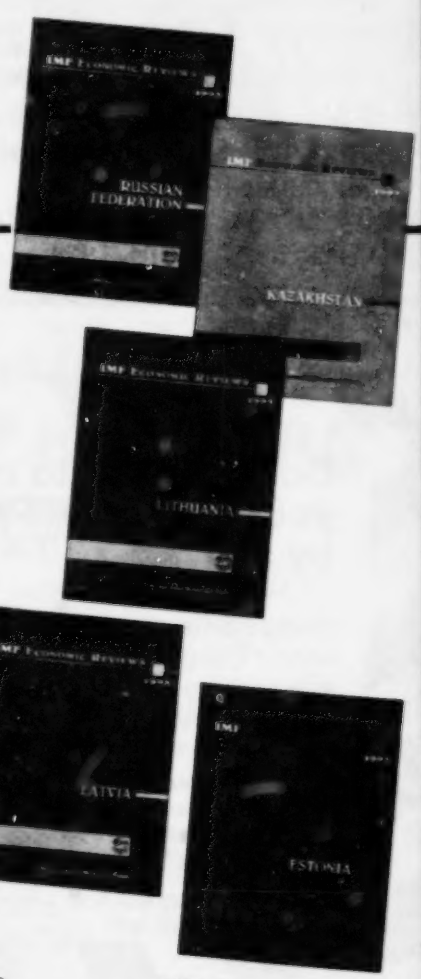

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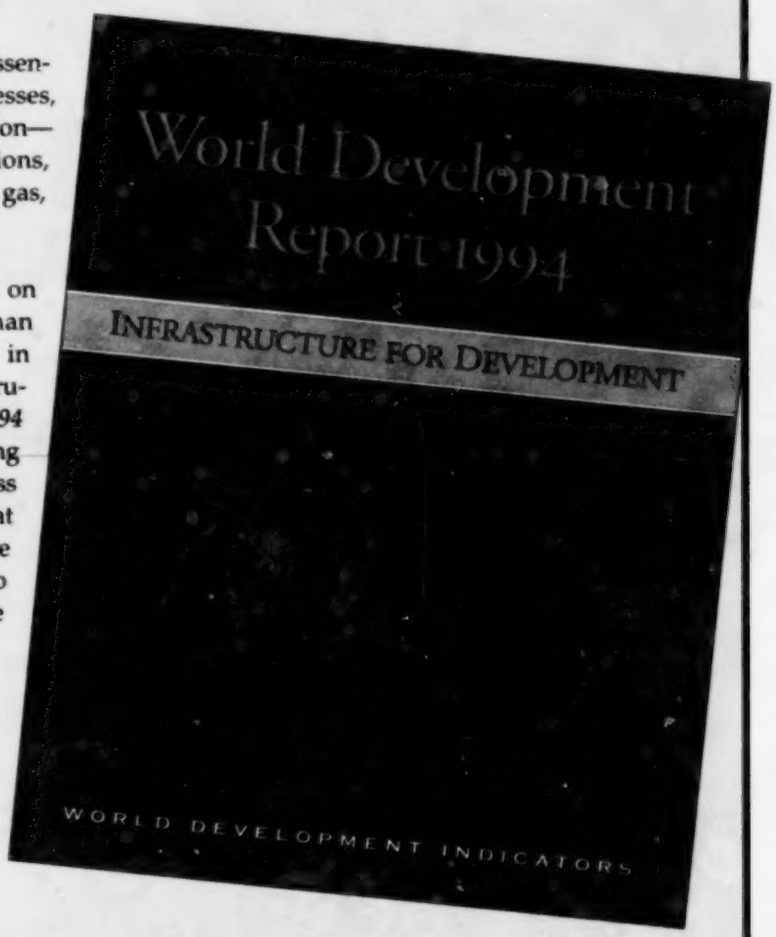

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